99th Congress
1st Session

JOINT COMMITTEE PRINT

S. PRT.
99-110

TOWARD AN ECONOMY WITHOUT DEFICITS

A 1985 YEAREND REPORT ON THE U.S. ECONOMY

PREPARED FOR THE USE OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

BY THE

REPUBLICAN MEMBERS

OF THE

JOINT ECONOMIC COMMITTEE

JANUARY 10, 1986

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
55-819 O WASHINGTON : 1986

J842-1

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LETTER OF TRANSMITTAL

December 18, 1985.

Hon. DAVID R. OBEY,
Chairman, Joint Economic Committee, Congress of the United States, Washington, DC.

DEAR MR. CHAIRMAN: I am pleased to transmit a 1985 yearend review of the U.S. economy entitled "Toward an Economy Without Deficits." This report was prepared by Republican Members (Senators James Abdnor, William V. Roth, Jr., Steven D. Symms, Mack Mattingly, Alfonse M. D'Amato, Pete Wilson and Representatives Chalmers P. Wylie, Daniel E. Lungren, and Bobbi Fiedler) of the Joint Economic Committee for the use of the committee and the Congress.

As we begin 1986, the economy continues the expansionary path that it has followed for the past 3 years. We hope that the enactment of the Gramm-Rudman-Hollings legislation will help assure that expansion.

Persistent concerns about the economic effects of huge Federal budget deficits make it imperative that we look several years ahead and ask two key questions:

- What would happen if we failed to follow through and balance the budget within the next several years?
- How would the economy respond to a program of deficit reduction?

We conclude that a specific schedule of deficit reduction--accomplished by reducing outlays, not by raising taxes—is essential.

We reject fears that deficit reduction through spending cuts would send the economy reeling into recession. Problems exist, but they are manageable. The essential point is that deficits have persistent harmful effects—particularly in our foreign trade and in our ever-growing burden of interest payments—that must be dealt with forthrightly. If we let deficits persist beyond 1991, we will have inflicted irreparable harm on the economy and upon future generations of Americans.

The views expressed in this report are those of Republican Members of the Joint Economic Committee.

Sincerely,

JAMES ABDNOR,
Vice Chairman, Joint Economic Committee.

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I. 1991: A BUDGET ODYSSEY

The patient was informed by his dentist of the good news/bad news of his checkup. The teeth were fine, but the gums had to go. The American economy looks bright and sharp for at least the next 12 months, but the growth in Federal deficit spending is causing long-term economic rot.

After experiencing the economic devastation of runaway inflation during the late 1970's, we're now faced with the prospect of runaway debt. Congressional Budget Office baseline projections have the public debt increasing over 80 percent between 1985 and 1990, from $1.522 trillion to $2.750 trillion. And, by 1990, net interest payments as a Federal outlay will approach Federal expenditures for nondefense discretionary programs—programs such as mass transit grants, urban development action grants, farm loans, student financial aid, and health research. We shudder at the consequences if a severe recession should strike between now and 1990, causing Federal outlays and debt to substantially exceed, and revenues to fall below, baseline projections. Even assuming that CBO baseline projections prove correct, *net interest payments as a Federal outlay will consume 41 percent of individual income tax revenues in 1990!*

Said another way, while congressional tax reformers labor to reduce tax rates incrementally, the rate reductions that would be possible without the burden of interest payments are quite remarkable. Personal income taxes could be cut 20 percent, payroll taxes by 25 percent, and there would still be room to cut the corporate tax in half.

In this study, we try to envision an economy without deficits. We applaud the recent congressional and Administration action to enact a deficit reduction package. Of course, the national debt, and interest payments on it, will go on for decades. But our goal is to stop the accumulation of debt in its tracks, and to stop adding to our already heavy interest burdens.

The current debt track—to mention nothing of an exploding debt—presents a clear and present danger to the American traditional democratic economy. Nikita Khrushchev notwithstanding, we would have buried ourselves and suffocate in our own debt. Every Member of the United States Congress took the oath of office to defend the Constitution of the United States against all enemies, foreign and domestic. Our national debt is proving to be a formidable opponent, and we are glad to see that Congress has answered this call to arms.

II. WHERE IS THE ECONOMY HEADING DURING THE NEXT 12 MONTHS?

As the current economic expansion begins its fourth year, many economists and financial executives are pessimistic, not because there are significant signs of weakness in the economy, but on the simple theory that expansions succumb to an aging process; they have an age limit, and therefore a recession is "just around the corner."

No Recession in 1986

We see no signs of recession in 1986.

There is no set pattern, no set length, for a "typical" recovery. The nine postwar II economic expansions have ranged from 12 months (July 1980 to July 1981) to 106 months (February 1961 to December 1969). The latter near-decade expansion was sustained by the 1963 Kennedy tax cuts (which went into effect in 1964).

The average age of postwar II expansions (including the Korean and Vietnam War periods) is 45 months. Based on that postwar average, the current expansion, which is 36 months old, should expire in August 1986. But who says this is a "typical" or average expansion? Is any expansion "typical" or average? The current expansion could go on for some time.

The usual signs of recession are not present. There is no excessive inventory buildup; production is not bumping up against factory capacity; there are few pockets of labor shortages; inflation is very low; interest rates are declining; while consumers have large debt burdens, they are manageable; and business debt burdens are well within safety zones.

The year 1986 may not be "robust" but it will be a very good year. We expect real GNP to rise by 4.0 percent, and unemployment to edge down to about 6.8 percent by the end of 1986.

In a sense it might be argued that the "next" recession has already come and gone. We have a "growth recession" during the first two quarters of 1985, with GNP rising only at a 1.1 percent annual rate over the period. Having paused to catch its breath, the economy is now moving upward again, and it can be argued that we are in the early stages of a vigorous new recovery.

Admittedly, there are both pluses and minuses in the economy, but on balance the pluses outweigh the minuses.

Negative Factors

On the negative side, there are serious long-standing problems in agriculture and manufacturing. U.S. farmers are still stuck in the recession that began in 1981. Cash farm marketing receipts are running $8 billion *below* their level in 1981. Real net farm income

in the second quarter of 1985 was $8.6 billion, 22 percent *below* the level of 1981, and 41 percent *below* the level of 1979.

In manufacturing, employment in October 1985 was one million less than it was in 1981, this at a time when employment in the economy as a whole had risen by 8 million over the same period.

This year's 13½ percent decline in the value of the dollar against 10 major industrial currencies, and the prospects for further declines, should help make our manufctured goods and our farm commodities more attractive in the world marketplace; we may see some improvement in manufacturing and farm export sales, and some decline in manufacturing imports late next year, after the usual 12 to 18 month lag in trade response to dollar value changes. Unfortunately, this may come too late for many businesses and farmers.

A positive factor the past several years that could turn into a negative factor is foreign investment in the United States. Since 1981, foreigners have invested more than $275 billion in both direct and portfolio investment here. This has helped finance our $200 billion fiscal deficits, particularly in the face of low U.S. savings rates. But there is a risk that foreign investors may reduce their U.S. investments because of declining U.S. interest rates and a strengthening of investment opportunities elsewhere as other economies expand. Also, there could be an erosion of confidence in the U.S. economy due to our large public and private debt burdens, and to our huge trade deficits. If foreigners sharply curtail their U.S. investments, it could bring a plunge in the dollar, and U.S. interest rates could shoot up. However, we do not expect that to happen.

Widespread financial problems in the farm credit system and the savings and loan industry not only undermine confidence in those industries, but also have ripple effects throughout the whole economy.

Debt burdens in the economy as a whole are high—not dangerous, but high. Private nonfinancial debt has risen from 1.4 times GNP in 1978 to 1.6 times GNP in 1984. Excessive debt burdens have the potential to retard growth and lead to recession. This occurs when lenders refuse loans to heavily debt-burdened borrowers, or will offer loans only at higher rates.

We must close the gap between debt and savings in the U.S. economy. The best place to begin is with the Federal deficit.

Heavy consumer debt burdens could slow consumer spending in 1986. While total household liabilities (including mortgage debt) as a percent of total assets have changed very little the past few years, consumer installment credit as a percent of disposable income reached an all-time high of 19.0 percent in September 1985, 4 percentage points above the average of the 1980–1982 period. Consumer spending will be good in 1986, but will not increase as much as it did in 1983 and 1984, because of these unusually heavy debts. Consumer spending accounts for nearly two-thirds of GNP; thus any slowdown in this sector has important consequences for the whole economy.

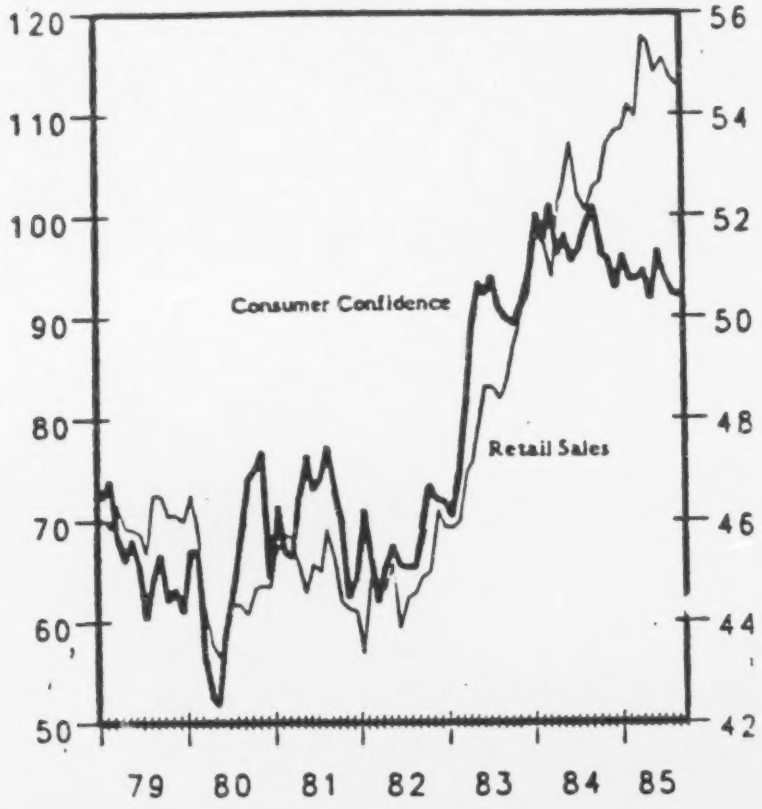
One important unknown in this scenario is the expected state of consumer confidence in 1986. Right now it looks good. If it holds up at or near current levels, we may see no slackening in consumer

spending at all in 1986. On the other hand, based on past performance, confidence could take a dip.

University of Michigan surveys show consumer confidence at record highs, and that's the problem. It has been high, but flat for two years now. Even though general economic news is good, consumers are fickle and they want even better news or they get "depressed"; even in good times, they challenge the economy, "what have you done for me lately?"

Consumer confidence rose sharply in 1982 and 1983, then flattened out in 1984 and 1985. Real retail sales tracked consumer sentiment very tightly in 1982 and 1983, but retail sales kept growing rapidly in 1984 and 1985, while sentiment flattened, creating a large gap between retail sales and consumer confidence (see chart below).

CHART II.1.—Consumer confidence (left scale, percent) and real retail sales (right scale, billions of 1972 dollars).



Source: Data Resources Inc.

If consumers slow their spending, 1986 will be a year of moderate growth—in the 2½ to 3 percent range, but no recession. If consumers do not retreat, and business spending holds up, as we expect it to, 1986 could be as very good year, with real GNP rising by something in the neighborhood of 5 percent. Our best guess, however, is something in the middle—a 4.0 percent growth in real GNP, unem-

ployment falling gradually to 6.8 percent by yearend 1986, and real incomes rising for most Americans.

Positive Factors

Turning then to the positive factors justifying a fairly optimistic outlook, the most positive statistics are extremely low inventory-to-sales ratios. In total manufacturing and trade, that ratio stood at 1.35 percent in September, right near its all-time low. What this means is that "the shelves are empty" and any increase in demand translates immediately into new production and employment. This bodes well for output and employment gains in 1986.

Corporate profits should rise next year and this will help spur business fixed investment. Although final data will not be available for some time, it appears that pre-tax profits took a dip this year, falling by 2 percent, after increases of 23 percent in 1983 and 16 percent in 1984. Prospects for a profit turnaround next year are good (in fact, that turn around may have already begun). Not everyone is predicting it, but the majority of the forecasters are. However, the estimates range all over the lot. The 50 Blue Chip forecasters show profits ranging from a decline of 5.6 percent to an increase of 27.8 percent. The average of the 50 forecasts is a 7.1 percent increase. We believe this is low. We estimate a 15 percent rise in pre-tax corporate profits next year.

If profits do rise somewhere in that range, the cash flow and business confidence resulting thereform should have a very favorable effect on business plant and equipment spending and, in turn, this high-powered form of spending will have a very beneficial effect on the economy as a whole.

In this connection, we believe the August–September McGraw-Hill Survey of business investment plans for 1986 is off the mark. That Survey has business fixed investment *declining* 5.4 percent, after inflation adjustment, in 1986. This is most unusual in a time of economic expansion.

The McGraw-Hill Survey was taken in late summer when there was considerable pessimism in the economy. We believe there are powerful forces at work to bring a fairly strong rise in real business fixed investment next year—about 6 percent. Factors justifying this optimism are (1) the above forecast of good corporate profits; (2) the dollar continuing to decline and to stay down; (3) fairly rapid real GNP growth—4.0 percent; (4) the likelihood of some edging up of capacity utilization rates; and (5) stable or lower interest rates. With all of these factors converging, real fixed business investment cannot do anything but rise next year.

It is quite important that we have substantial capital spending to take up the slack from any anticipated slowdown in consumer spending. Investment spending is high-powered spending. It creates jobs. It improves productivity and lays the foundation for long-run economic growth.

The real keys to the future are inflation and interest rates. As long as these behave as they have recently, the recovery is relatively safe. Rising interest rates would stop housing construction in its tracks, put the brake on auto sales, slow other consumer spending, and stamp out business investment.

Though there are many determinants of interest rates, none is more important than inflationary expectations. We are optimistic on inflation, and, therefore, we are optimistic on the outlook for interest rates.

The inflation psychology that was build into the system in the last half of the 1970's is finally beginning to wane. It took several years for the psychology to bore into the system, and it takes several years to root it out. It took seven years for consumer prices to grow from the 3.4 percent annual rate of change in 1972 (and where it is right now) to the 13.3 percent peak increase in 1979. We have been working off from that 1979 peak for six years now, and the expected 3½ percent inflation next year will give us seven years of reduced inflation. Surely by next year real interest rates will come down in response to subdued inflationary expections.

In addition to the time-healing of inflationary psychology, there are some real economic factors at work to hold down inflation.

Wage increases are projected to remain moderate. The slowing of inflation reduces cost-of-living adjustment, and thus disinflation feeds on itself. Also, the memories of the 1981–1982 recession and high unemployment linger with labor and serve to temper wage demands. Workers prefer job security to large wage settlements. The inflation-driven panic during wage negotiations is simply not present anymore.

OPEC will likely continue to exceed production quotas, and oil prices will continue to fall. OPEC has two problems: a political problem—it can't keep its members in line, and an economic problem—a worldwide decline in oil demand due to conservation and relatively slow economic growth. The resulting oil glut will keep downward pressure on these important prices. There are also surpluses in some metals and other basic commodities.

Productivity, though volatile, will rise at a much faster pace than during the sluggish 1978–1982 period, and this will reduce unit labor costs, a key element in pricing. Productivity improvements would be bolstered by enlightened tax policy, reduced inflation, and thus reduced distortions of profits and capital consumption, reduced regulatory restraints, better trained and educated workers, increased R&D spending, union willingness to reduce restrictive work rules, and better union-management cooperation aimed at productivity improvements.

In the last analysis, the inflation outlook depends on what the Federal Reserve System does. We see no signs of irresponsibility on the part of present and future Governors of the Federal Reserve. The Board seems to be doing a good job of walking the tightrope between inflation and recession. We trust the Board will keep its balance as it continues this precarious journey. (Monetary policy is discussed in Chapter V of this Report.)

If inflation stays calm and interest rates do not rise, the final phase of this expension will not occur very soon; it could go on for several more years, and certainly through 1986.

Effects of Congressional Action on the Federal Deficit

Congress recently enacted a deficit reduction package. How will that affect the above-portrayed optimistic economic outlook for 1986?

First, it must be assumed that this will be accepted as a credible package—not a "political" package. Financial experts have a way of sniffing out when Congress is playing games. If the markets suspect hanky panky or insincerity on the part of Congress, we will either get no beneficial economic effect or even a negative effect from budget action.

Assuming the markets accept this as a genuine package, there could be a number of positive surprises for the economy over the next 12 months. Even though no real dollar effects of deficit reduction take place in fiscal 1986, the psychological or rational expectations from the enactment of a multi-year deficit reduction package could have very beneficial effects on the financial markets and the economy as a whole.

The fact that Congress has finally put its act together gives a clear signal to the markets that deficits are going down and are to be eliminated by sometime in the 1990's. Interest rates will decline further, perhaps as much as 1½ to 2 percentage points on long-term issues. Furthermore, housing starts will increase by 100,000 to 200,000 annually, furniture and appliance sales will rise, and current strong automobile sales will be sustained. Businessmen will cast aside doubts about the sustaining power of the expansion and will step up plant and equipment spending.

The recent bond market rally—and the decline in interest rates—reflected some anticipation of congressional deficit action. However, now that action has finally come, it should give a further healthy boost to confidence and optimism, a continuation of the bond rally (although at a reduced pace), a new burst of strength in the stock market, and beneficial effect throughout the whole economy.

Enactment of the deficit reduction package is a clear plus for the economy in 1986 and beyond.

III. FEDERAL FISCAL POLICY: THE EMERGING DEFICIT CRISIS

The Emerging Budget Crisis

Past and Future Budget Trends

Despite broad agreement that current budget trends are unsustainable, Federal spending and deficits are still out of control. In fiscal 1985 Federal revenues increased $67.5 billion, but Federal outlays rose by $94 billion, the largest one-year increase in American history. Consequently, the deficit expanded from $185.3 billion to $211.9 billion.

Between fiscal 1963 and 1985, Federal spending climbed from $111.3 billion to $946 billion, an increase of 144 percent in real terms. The Federal outlay share of gross national product also trended upward during this period. As a result, the Federal outlay share of GNP in 1985 amounted to 24.7 percent of GNP, far above its postwar annual average of 21 percent. Federal receipts of $734 billion in the same year claimed 19.1 percent of GNP, a level almost identical to the postwar average. Consequently, the fiscal 1985 budget deficit of $211.9 billion was about 5.5 percent of GNP. An annual real GNP growth rate of 4.1 percent would have been required to prevent the outlay share of GNP from rising. Rising Federal outlays, not tax cuts, are the source of the large structural deficits we now face.

TABLE III.1.—FEDERAL BUDGET AND THE GROSS NATIONAL PRODUCT, SELECTED YEARS

[Amounts in billions of dollars]

Year	Budget receipts		Outlays		Deficit/surplus	
	Amount	Percent of GNP	Amount	Percent of GNP	Amount	Percent of GNP
1963	$106.6	14.4	$111.3	19.3	$4.7	1.0
1968	153.0	18.4	178.1	21.4	−25.2	3.0
1973	230.8	18.4	245.7	19.6	−14.9	1.2
1978	399.7	19.1	458.7	21.9	−59.0	2.8
1980	517.1	20.1	590.9	22.9	−73.8	2.9
1981	599.3	20.8	678.2	23.5	−78.9	2.7
1982	617.8	20.3	745.7	24.5	−127.9	4.2
1983	600.6	18.6	808.3	25.1	−207.8	6.4
1984	666.5	18.6	851.8	23.8	−185.3	5.2
1985	734.0	19.1	945.9	24.7	−211.9	5.5

Underlying these trends in the budget totals is the dramatic change in the composition of budget outlays since 1963. In 1963 transfer payments amounted to $31 billion, or 28 percent of total outlays. In fiscal 1985, these payments amounted to $427 billion, or 45 percent of total outlays. This is a real increase of 358 percent for

the period or an average increase of 7.1 percent per year. Meanwhile, defense spending has gone from $53.4 billion, or 48 percent of outlays, to an estimated $249 billion, or 26.5 percent of the total. In constant 1972 dollars, this represents an increase of less than 2 percent per year during the last two decades.

Changing economic conditions explain part of the fact that Federal spending amounts to a larger share of the economy now than in the early 1960's, but policy changes are even more important. This is seen in the astronomical rate of increase in transfer payments since 1963.

The abandonment of fiscal restraint in the "Great Society" decade of the 1960's led to the enactment and dramatic expansion of domestic programs, without adequate consideration of potential future costs. This resulted in the expansion of such programs well beyond anything their proponents or anyone else thought possible or desirable. The relaxation of fiscal discipline affected other elements of domestic spending as well. The roots of this problem are discussed in the next section.

Federal budget control has important implications for the prospects of future economic growth. The resources devoted to funding any Federal expenditure must be extracted from the private sector by taxation, borrowing, and/or inflation. It can be argued that at the margin the costs these extractions impose on the economy now exceed the benefits provided by Federal expenditures. Not only are resources diverted from private uses, but additional costs are generated as well. For instance, the economic cost imposed by the level of current marginal tax rates may well be more than the revenue collected. It also includes a "marginal excess burden" in the form of tax compliance expenses and disincentives to work, save, and invest. Unless Federal program benefits at the margin exceed their budget cost, the expenditure should not be made.

In our Midyear Report, we urged Congress to take the necessary steps to reduce baseline outlays and budget deficits in coming years. Without strong action under current services, expenditures will rise by an annual average of $92 billion between fiscal 1986 and 1990. By exceeding projected revenues by an annual average of almost $18 billion, the pace of outlay growth will force forecast deficits to the magnitude of $285 billion by 1990.

TABLE III.2.—BASELINE BUDGET PROJECTIONS

(By fiscal year)

	1986	1987	1988	1989	1990
In billions of dollars					
Revenues	787	853	931	1,002	1,083
Outlays	1,000	1,082	1,174	1,266	1,368
Deficit	212	229	243	264	285
Publicly held debt	1,733	1,961	2,203	2,466	2,750
As a percent of GNP					
Revenues	19.0	19.1	19.3	19.3	19.4
Outlays	24.2	24.2	24.4	24.4	24.4
Deficit	5.1	5.1	5.1	5.1	5.1
Publicly held debt	41.9	43.9	45.8	47.5	49.1

Source: Congressional Budget Office

Much more damaging than the short-term economic problems caused by the deficit is the long-term threat of a rapidly growing national debt. Under current baseline projections, $1.2 trillion would be added to the publicly held national debt between 1986 and 1990. This 81 percent increase in the national debt would shift much of the cost of current expenditures onto future taxpayers. The debt-to-GNP ratio is not now extraordinarily high by historical standards, and its rate of growth is reason for serious concern, since it represents a claim on future income. The moral dimension of shifting the costs of current consumption to future generations should not be ignored.

Net interest costs under the baseline are projected to increase $15 to $20 billion a year through 1990. By 1990, Federal net interest costs would amount to $210 billion, or 3.8 percent of GNP. This represents a growing burden as a greater share of the budget is devoted to servicing the national debt. *By 1990, the net increase costs of the Federal Government would amount to 41 percent of individual income tax collections!*

In addition to the concerns raised by the rate of growth of national debt, debt service costs are also more vulnerable to rapid and unforeseen increases than in the past. Interest rates are generally higher than in previous periods of relatively high national debt. An unexpected increase in interest rates over the next 10 years could create an extremely difficult—perhaps unsolvable—budget problem. In any event, rapidly growing net interest costs would crowd out the other budget functions, and could eventually generate pressures for huge tax increases. A huge tax increase, in turn, would lead to lower economic growth, perhaps a recession, and even higher government expenditures.

In recognition of the severity of current budget trends, Congress recently approved a 1986 budget resolution mandating a substantial reduction in budget deficits over the next five years. This declining deficit path would result in a 1990 budget deficit of $120 billion, or about 2 percent of GNP. Virtually all of this deficit reduction would be achieved by restraining the growth of outlays relative to tax receipts. If this policy is implemented, the threat of hemorrhaging deficits will be virtually removed. Unfortunately, very few people expect the provisions of the resolution to be adhered to. Already it appears that outlays will exceed the resolution's fiscal 1986 level of $965 billion. Furthermore, slower than expected economic growth could result in slightly lower revenues in fiscal 1986. More serious is the prospect that Congress will be unable to restrain expenditures in the four following fiscal years, leaving out-year budget deficits near the unsustainable baseline levels. There is broad recognition in the Congress that much of the projected savings in the fiscal 1986 budget resolution are overstated, and that real savings will be very difficult to achieve. The resulting climate of frustration and anxiety created a fertile environment for a reform along the lines of the Gramm-Rudman-Hollings Amendment.

TABLE III.3.—THE BUDGET OUTLOOK WITH POLICIES OF THE 1986 BUDGET RESOLUTION

[By fiscal year]

Estimate	CBO projection			CBO extrapolation	
	1986	1987	1988	1989	1990
In billions of dollars:					
Revenues	790	858	939	1013	1094
Outlays	965	1021	1082	1145	1214
Deficit	175	163	143	132	120
Debt held by the public	1,701	1,861	2,002	2,133	2,252
As a percent of GNP:					
Revenues	19.1	19.2	19.5	19.5	19.5
Outlays	23.3	22.9	22.5	22.1	21.7
Deficit	4.2	3.7	3.0	2.5	2.1
Debt held by the public	41.1	41.7	41.6	41.1	40.2

Source: Congressional Budget Office

The Case for Institutional Reform

For most of American history the principle of a balance budget governed the policy of all major political parties. Over the last few decades, the orthodox policy of balanced budgets has been undermined by those who have argued that fiscal policy should be used to fine-tune the economy. According to James Buchanan and Richard Wagner:

> . . . the pre-Keynesian norm of budget balance served to constrain spending proclivities so as to keep governmental outlays roughly within the revenue limits generated by taxes. The Keynesian destruction of this norm, without an adequate replacement effectively removed the constraint. Predictably, politicians responded by increasing spending more than tax revenues, by creating budget deficits as a normal course of events.

The policy of "functional finance" recommended intentional creation of a deficit during periods of slow growth as a way to increase aggregate demand and restore full employment. Through well intentioned, these doctrines were disastrous in their actual impact. By breaking the taboo against deficit spending, and making it respectable, the new policy removed a broadly accepted limit upon Federal spending. No longer did the level of Federal receipts limit the inherent tendency of Congress to maximize funding for constituent programs. Though often viewed as something of a relic from the dark ages, the balanced budget doctrine did address this institutional problem effectively.

In this regard, it is useful to distinguish between active deficits (created by policy) and passive deficits, now often also referred to as structural and cyclical deficits, respectively. A passive deficit occurs as a result of an economic downturn as revenues are reduced and transfer payments increase. Traditional public finance recommended either previous accumulation of surpluses to cover this kind of deficit, or its temporary toleration. What was new in the 1960's was the view of functional finance, which saw the goal of fiscal policy not to balance the budget, but to balance the economy. This idea relies on the notion that the private economy is inherent-

ly unstable, and requires an active fiscal policy to correct recession (by deliberate creation or enlargement of a deficit) or inflation (by creation or enlargement of a surplus). The balance between the revenue and expenditure side of the budget was subordinated to this objective.

Though in theory the budget was to be balanced over the business cycle, without the balanced budget constraint deficits recurred in good times and bad. Without it, the Nation embarked on a course of larger and larger deficits. Moreover, many Federal programs were expanded and new ones created after the mid-1960's with inadequate thought given to the future costs they would generate—programs which were so politically sensitive that they couldn't be cut, deficit or no deficit.

In the absence of a balanced budget rule, rational evaluation of program costs and benefits becomes almost impossible. Ideally, such an evaluation would require that each item of expenditure be linked to a specific tax measure. This would allow the Congress to make an informed judgement about whether the program is cost effective. Alternatively, at least the overall level of spending should be connected to the level of tax revenues. This would force the Congress to choose budget priorities in keeping with the level of projected tax revenues as provided by law. Without a specific or even general link between program expenditures and taxes, chronic overspending has and inevitably will result.

Absence of a balanced budget rule introduces an asymmetry into fiscal decisionmaking. While the merits of each expenditure are visible, and often amplified by lobbyists, the costs of the decision are not. A vote for a particular constituent program will include the consideration that only a small part of its expense will be borne by the beneficiaries. Furthermore, by resorting to debt financing, the costs can be shifted forward onto future taxpayers, most of whom are not currently represented in Congress. The prospect of current and future diffusion of program costs introduces an inherent spending bias into democratic legislatures. This chronic inability to properly evaluate program costs and benefits has been termed "fiscal illusion." This institutional defect must be addressed if deficit reduction efforts are to be successful.

Under a balanced budget rule, the proclivity toward excessive expenditure would be constrained. A higher level of funding for all Federal programs still might be achieved, but the Congress would be forced to enact a tax increase to support it. If the increase took the form of a general rise in personal income taxes, the cost of the additional spending would be borne by the taxpayer. The taxpayer/voter would not be deluded into thinking he is getting something for nothing. An excessive level of spending may still result, because special interest groups are better organized and motivated to exert pressure in support of a favored program than are millions of taxpayers who may oppose it. The diffusion of taxpayers gives rise to prohibitive transactions and information costs, which mean the taxpayer's interests will tend to be underrepresented and disorganized in any particular instance. Thus, constitutional or other budgetary reforms should include tax limitation provisions which ensure that the reform will not become an instrument of "revenue enhancement."

One dimension of the problem can be illustrated by using the analogy of 20 people dining together at a restaurant. If they agree beforehand that each will pay his own check, the resulting total amount spent will likely be lower than if they agree beforehand to divide one check evenly for the entire group. In the latter arrangement, an individual's frugality will not lower his bill significantly, but may only result in his subsidizing of his associates.

In summary, the balanced budget rule limits Federal spending growth. That's why special interest groups and their allies in Congress will always oppose such a rule, whatever its form. Without such a rule, there is little or no institutional restraint on congressional spending.

Some ridicule efforts at institutional reform. "If we want to reduce the deficit, let's vote to do it, instead of voting for some change of rules to that end." This argument, of course, misses the point that the central problem is in the ground rules of the budget process. Unless one is prepared to assert that constitutional—or other—ground rules are necessarily meaningless, this argument is less than compelling.

Institutional Reform of the Budget Process

No instrument of policy can compensate for the inability of Congress to reach agreement on a policy to deal with runaway Federal spending and deficits. The current budget process has failed to restrain Federal spending growth. In addition, the budget cycle timetable and other procedural aspects of the Budget Act are routinely ignored or circumvented. Only one element of the act—reconciliation—has proved capable of effecting needed budget changes, in a way that was never intended by the authors of the act. Even the innovative use of reconciliation as an instrument of budget control, for all its earlier successes in the early 1980's, cannot remedy the basic institutional problems. Under current conditions there is an inherent spending bias in the legislative branch. Reconciliation is most effective as an instrument when a consensus can be reached on a policy of fiscal restraint. However, under existing ground rules there is little likelihood that such a consensus can be achieved, given the magnitude of the problem at hand.

The Balanced Budget Constitutional Amendment

The Balanced Budget/Tax Limitation Constitutional Amendment would require a balanced budget in all but extraordinary circumstances. Section 1 of the Amendment requires Congress to adopt a balanced budget plan prior to each fiscal year. Congress could waive the rule by a three-fifths vote in each chamber; otherwise, actual outlays would not be permitted to exceed planned outlays. However, a deficit from a revenue shortfall, resulting from a recession, would be tolerated. Section 2 states that the rate of planned revenue growth may not exceed the growth rate of national income, unless a majority of *all* Members of both Houses of Congress pass a tax bill that has become law. Since the level of Federal receipts and spending normally must balance, section 2 also indirectly places a limit on the growth rate of Federal outlays. In addition, there is an escape clause in the event of war.

The Gramm-Rudman-Hollings Amendment

In our annual report earlier this year, we recommended that Congress enact S. 57, the Deficit Reduction Act, introduced by Senator Abdnor. Its basic features were recently incorporated in the so-called Gramm-Rudman-Hollings Amendment. This measure requires Congress to reduce the budget deficit by $36 billion a year, starting with the next fiscal year. If Congress fails to achieve the required deficit reductions, the process is backstopped by a sequestering procedure under which the President could make the needed reductions across-the-board, except for Social Security. Although the requirement that cuts be across-the-board makes any sequester an unwieldy and blunt instrument of budget control, exempting items from the sequester order tends to undermine the effectiveness of the whole measure. Exempting programs from the sequester decreases the amount of total outlays in the pot, thus making effective sequestration much more difficult, and giving proponents of the exempt programs no incentive to agree to meaningful cost savings in the regular budget process. Furthermore, those forced to bear a disproportionate burden of spending cuts have a powerful incentive to call for a huge tax increase.

The original Gramm-Rudman-Hollings Amendment was not the perfect solution to excessive Federal spending and deficits. Close examination revealed a number of problems regarding definitions of programs subject to sequester, constitutionality of CBO involvement in the sequester process, and awkwardness of the "meat-ax" approach to budget control, should it be invoked. It was subsequently amended to address these problems. Since congressional enactment of this measure, the prospects for budget control have been greatly enhanced.

While the constitutional amendment is a good long-term reform, some transitional adjustment would be needed to make it workable upon its ratification. Something like Gramm-Rudman-Hollings is needed to restore budget control as an end in itself, but also to establish a fiscal position under which a constitutional amendment could be adopted without disruption.

The House of Representatives initially passed an "alternative" to Gramm-Rudman-Hollings that was designed to fall apart. Enough items were exempted to make sure any sequester could not work. Just to make certain the legislation would be totally ineffective, it was carefully crafted to amplify all the constitutional objections the Democrats themselves raised during the course of the debt limit conference. For example, the argument was made that involvement of CBO in an action of the Executive Branch was an unconstitutional violation of the separation of powers. The House's alternative was to make the CBO the *primary* agency involved in triggering any sequester. They seized on the potential constitutional problem they identified, and broadened it as much as possible. Furthermore, an extraordinary non-severability clause was included whereby the entire bill would be null and void if any one part of it was declared unconstitutional. Not surprisingly, the House inserted a provision requesting an early court test of the legislation.

Tax Reform

In raising a given amount of revenue a tax system may be structured in a variety of ways, depending on policy considerations. Three commonly cited criteria of tax policy are economic efficiency, equity, and simplicity. How these criteria are balanced in any particular tax system is controversial because in some ways they are mutually exclusive. For example, many notions of economic efficiency would be impossible to express in legislation without great complexity. Corporate taxation will unavoidably be very complicated, regardless of the other objectives pursued. There is obviously a deep conflict between redistributionist views of equity and others' views of economic efficiency. One reason the current tax code is such a problem is that it is a compromise between the three different criteria cited above.

The most important criterion is that of economic efficiency. An efficient tax is one that does not alter the relative prices of alternative goods or activities from what they would be in the absence of taxation. A tax that does not alter decisionmaking from that of a no-tax world represents the ideal of a neutral tax.

The current tax code obviously does not correspond to anyone's view of tax neutrality. Innumerable tax provisions currently favor one kind of activity over another, or one group of taxpayers over another. Not only are certain industrial sectors harmed by such discrimination, but the economic welfare of the whole community is lowered by a wasteful misallocation of resources.

The most important distortion inherent in any income tax system is the double taxation of saving. Not only are amounts saved subject to taxation, but the return to such saving is also taxed. This punitive treatment of saving raises its after-tax cost relative to consumption, encouraging more consumption and less saving. Recent research by Michael Boskin and others has established that saving is responsive to the rate of return. Though this elasticity is less than one, it is sizable enough for income taxation to discourage saving significantly. The elimination of this bias is considered a primary goal of tax reform.

Equity is another important criterion of tax policy. Due to tax preferences two taxpayers with identical incomes may pay different rates of tax. This violates the principle of horizontal equity, which states that similarly situated taxpayers should pay the same amount of tax. The lack of horizontal equity in the current tax system—riddled with loopholes, some of them justifiable, others not—is the source of much public frustration and unhappiness. As the tax reform debate this year has shown, some of the most egregious loopholes are politically untouchable, while many "good" loopholes are constantly under attack. In the latter category are tax provisions designed to lessen the tax bias against saving and investment. But even here, while these are needed for economic efficiency, they give rise to situations which violate horizontal equity.

Another view of equity is provided by the concept of vertical equity. According to this concept, tax rates should rise with income according to one's ability to pay. This notion relies on the idea that the marginal utility of income declines as income rises. However, because interpersonal comparisons of marginal utility are impossi-

ble to measure, no basis for designing a tax structure is provided by this approach. Any argument in favor of one degree of progressivity can be used to support virtually any other.

However, steeply progressive tax rates can be counterproductive even from the Treasury's point of view. As extensive hearings by the Joint Economic Committee have shown, the reduction of excessively high marginal tax rates facing upper income taxpayers can lead to an increase of revenue derived from this source. This is because lowering tax rates makes shelters and other forms of tax avoidance less attractive. Thus, since the 1981 Reagan tax cuts, the amount of revenues from the rich has risen, as has their share of the total income tax burden.

Simplicity is the third criterion of tax policy. The tax code ideally should be simple enough for citizens to understand. Common dependence on tax practitioners is just one indication that the tax code is excessively complex. While any tax system is bound to be complicated, unnecessary complexity should be avoided as much as possible. In addition, excessive complexity makes it difficult for the citizen/taxpayer to evaluate his cost of government services. To the extent this cost is obscured, the citizen/taxpayer will tend to underestimate the cost of the government services provided him, thereby encouraging a demand for services even when the benefits provided do not cover the tax cost.

Most economists and public officials would agree that the current tax system is inefficient and undermines economic growth. Given these acknowleged shortcomings, it is logical that we avoid raising increased revenues from the current tax code. This would tend to aggravate the already serious deadweight losses and inequities imposed by the current structure.

Those individuals—economists as well as public officials—who promote a tax increase to reduce the deficit yet give only lip service to tax reform should be viewed with skepticism. While we firmly oppose a tax increase with or without tax reform, certainly a precondition of any tax increase would be tax reform. It is the height of hypocracy to criticize the current tax code as disadvantaging the poor while maintaining an "open mind" regarding a tax increase.

Furthermore, Federal spending patterns clearly show that higher revenues would probably encourage a surge in Federal outlays, without putting a dent in the deficit. This exercise would inflict severe damage on the economy and promote an expansion of the Federal sector. This would give us the worst of all possible worlds.

Instead, a revenue neutral tax reform package should be enacted which removes the existing tax bias against saving and investment.

Conclusion

Current budget trends, unless corrected, will lead to an 81 percent increase in publicly held national debt by 1990. The best strategy for dealing with the budget crisis is to restrain Federal spending growth while adopting policies to ensure continued economic expansion. If Congress were to hold the growth rate of Federal spending to less than that of the economy, these expenditures as a share of national output would of course decline. At the same time,

a growing economy will raise tax revenues, resulting in lower deficits, both in absolute amount and as a share of the economy. However, it is unlikely that Congress would have been able to take the needed steps under institutional arrangements prior to the passage of Gramm-Rudman-Hollings. The existing spending bias is simply too strong, and it must be countered by an institutional reform that forces the Federal Government to live within its means. In addition, a revenue-neutral tax reform can contribute to solving our budget problem by removing existing tax barriers to economic growth.

IV. TOWARD AN ECONOMY WITHOUT FEDERAL DEFICITS

Recent budget deficits have reached levels without precedent during expansionary peacetime periods. Criticisms and condemnations of this situation have ranged from highly technical theoretical analyses to commonsense statements that we cannot indefinitely spend more than we collect in taxes. A consensus has formed in Congress and in the Administration that the budget deficits must be reduced, and it would be hard to find any officeholder who would claim otherwise. Yet, despite the ubiquitous denunciations of the deficit, warnings of impending disaster have not been borne out. As for remedial steps, actual deficit reduction has proved to be a political labor of apparent Herculean difficulty.

The purpose of this chapter is to review the economics of deficit reduction: why are deficits a problem; whom do they hurt; by what means might they feasibly be reduced; and what would happen to the economy if they were reduced? This analysis, it is hoped, will shed light on the difficult policy problems that will be with us for at least the next several years.

Origins of Current Budget Deficits

Budget deficits are nothing new. The Federal Government has spent more money than it has collected in taxes for 25 of the past 26 years. Yet, during the 1980's, the magnitudes increased greatly, so much so that the government's indebtedness has more than doubled since 1980. When President Reagan took office, he projected a balanced budget by 1985. Instead, there was a $212 billion deficit in FY 1985. In the early 1980's, the culprit was the recession, which was completely overlooked by overly optimistic economic forecasts. The recession caused a huge shortfall in revenues (apart from any effect of the 1981 tax rate cuts). More recently, excessive spending has been the main culprit. It resulted mainly from higher interest costs and from the failure to enact all the spending cuts that the Administration wanted. Lower-than-expected inflation also added to the deficit by reducing tax receipts by more than the resultant savings on indexed programs and other price-sensitive expenditures.

By now it has become painfully clear that spending is going to exceed revenues by vast amounts even while the economy is growing at a reasonable rate. And if a recession were to strike, the deficit would skyrocket. In other words, deficits are no longer an accident, but a direct result of conscious policy decisions, which is why they are now termed the "structural deficit."

Short-Term Consequences of Large Budget Deficits

The budget deficit has not brought many of the problems that were widely feared only a few years ago. Inflation has not ex-

ploded; interest rates have declined rather than increased; and investment has not been noticeably crowded out. The reasons for these favorable happenings stem from the course of monetary policy and tax policy during the past five years and from developments in the international sector.

Based on past experience, big budget deficits were thought to make inflation inevitable. This was certainly true for recent Latin American examples of rapid inflation as well as for classic cases of hyperinflation. But in all of these situations, the monetary authorities accommodated the budget deficits with rapid expansion of the money supply, while in the United States our monetary policy was designed to clamp the lid on inflation (at least during the first several years of Mr. Volcker's chairmanship of the Federal Reserve). With tight monetary policy, inflation was halted, and this favorable development caused interest rates to drop. With lower interest rates (plus a growing economy and tax provisions favorable to capital formation), private investment has not been noticeably "crowded out" by massive public borrowing.

To be sure, budget deficits have generated some economic problems. The crowding-out effects have have been *shifted* from the interest-rate-sensitive sectors (where they were expected to occur) to the international-trade-sensitive sectors.

A significant portion of the deficit has been financed by direct borrowing from abroad. In 1984, we attracted $97 billion in capital from around the world. Foreign investors bought $22.4 billion worth of Treasury securities, and more than 13 percent of total Federal debt is owned to foreigners. An even greater portion of the deficit is being funded by domestic lenders who might otherwise have invested abroad. Between 1982 and 1984, U.S. banks' outflows declined from over $100 billion to practically nothing, directly or indirectly helping to finance the deficit.

In order to acquire dollars with which to buy U.S. debt, the rest of the world has had to run a surplus on the trade account. This has been one of the causes of a trade deficit of uprecedented magnitude, as merchandise imports (1972 prices) have grown 73 percent between 1980 and 1985, while merchandise exports decreased by 11 percent during the same period. Net exports (exports minus imports, in 1972 prices) have gone from a surplus equal to 3.4 percent of GNP in 1980, to a deficit estimated at 2.0 percent of GNP in 1985. Foreign investors' purchases of dollars helped to raise the value of the dollar in terms of foreign currencies. Other factors, like the safe-haven effect, also have pushed up the price of the dollar, and still others, like the rapid recovery of the U.S. economy from the recession while the economies of our trading partners grew more slowly, have contributed to the trade deficit. Nonetheless, the effect of the deficit on the dollar, and of the dollar on the trade deficit, is widely recognized. Since some industries are naturally more vulnerable to foreign competition than others, these trade effects were concentrated, mainly in agriculture and in certain manufacturing industries. Domestic-market industries, like housing, printing, and most of the service sectors, escaped these problems.

The cost of this restructuring involves the cost of shifting resources from disadvantaged industries to growth industries that re-

flect America's comparative economic advantage. This is a very real cost, expecially since it involves human suffering that is not easily quantified, and is only partially offset by benefits. The strong dollar has benefitted U.S. consumers of foreign goods (virtually everyone), and it has induced many of our exporting firms to become more productive and efficient. When the dollar declines, these firms will have positioned themselves for significant sales increases.

In summary, many of the expected effects of the budget deficit have been avoided owing to the character of monetary policy and to the tax cuts of 1981. The principal apparent effect of the deficit, thus far, has been a surge in imports and tougher competitive pressure on U.S. producers who must now compete in a domestic economy that is increasingly an extension of the world market.

Longer Term Effects

Deficit spending causes long-term economic rot. The deficit situation has been compared to that of a termite-infested house, which looks fine until the day it collapses. This might or might not happen, but even gradual deterioration is certain to become a major problem in time. Let us take a closer look at the dimensions of this problem.

Debt service.—The portion of the budget going to pay interest on the debt has grown rapidly. In the FY 1986 budget, interest payments are estimated at $137 billion, 14.2 percent of outlays. As recently as FY 1980, interest costs were just $52.5 billion, 8.9 percent of outlays. According to CBO baseline projections, interest would take up 15.4 percent of outlays in 1990. Clearly, writing out checks to pay interest on the debt is a large and growing function of the Federal Government.

This is a process that feeds on itself. As long as there is a deficit and, hence, a growing public debt, interest costs are bound to expand (unless interest rates fall greatly, which is unlikely when debt is growing). This is not an abstract economic theory; it is arithmetic.

Is there a danger of runaway debt, whereby Federal debt grows exponentially, ignites inflation, halts real capital formation, and brings political instability? The CBO does not project such an explosion, but it is noteworthy that CBO's February 1985 budget outlook devoted several pages to analysis of this possibility.

We will probably avoid a debt explosion, but every day we must live with the cost of paying interest. True enough, what is taxed from one person goes to another, so (aside from the growing payments to foreign holders of the debt) these payments tend to cancel out.

The real cost is known as the "excess burden," the indirect economic cost of higher tax rates at the margin. Higher tax rates reduced incentives to work, save, and invest and, hence, reduce economic growth. This is precisely the supply-side burden that tax reformers want to lighten by reducing personal and corporate tax rates. And while the tax reformers labor to reduce tax rates incrementally, the rate reductions that would be possible without the burden of interest payments are quite remarkable. *If, in FY 1986,*

we did not have to pay interest on the debt, the corporate tax could be cut in half, payroll taxes reduced by 25 percent, and there would still be room for a 20 percent reduction in personal income taxes. A supply-sider's paradise!

Unfortunately, such a world will never exist. No one is suggesting that we repudiate the debt, and it is simply too big to pay off. The best we can do is learn from the mistakes of the past and halt the inexorable growth of this burden by reducing the deficit.

Capital formation.—One of the principal means by which any economy grows is by the accumulation of capital. A higher ratio of capital to labor boosts output per worker. Equally important, much of the economy's technological progress occurs when new technologies are embodies in new capital equipment. Capital formation requires savings; when economy-wide savings rates fall, investment tends to fall. If capital formation slows down enough so that depreciated capital is not replaced, the Nation's capital stock can actually fall, as happened during one or more years of the great depression. This spells economic decline.

A government deficit means that one part of the economy is dissaving, putting a strain on the rest of the economy to maintain the aggregate rate of capital formation. As was mentioned above, a significant share of the deficit has been funded not out of reduced private investment, but out of net capital inflow from abroad. This has consisted not just of borrowing from abroad, but has also resulted from a sharp reduction of lending from U.S. capital-holders to foreign countries. As a consequence, at least in the short run, we have not had much crowding out of domestic investment.

But can this situation last for very much longer? Let us consider some of the ramifications of the crowding-out situation.

First of all, it is clear the the healthy investment performce of the economy since the end of the 1982 recession owes much to the ERTA tax provisions, which include generous depreciation allowances and an investment tax credit. But, by their nature, these provisions cannot cause a large permanent increase in the rate of investment. By increasing the after-tax rate of return on capital, they increased the optimal level of capital stock. (A company with $100 million in equipment desires instead to operate with $150 million worth of equipment.) It takes time—several years, perhaps—for firms to build up to their new desired capital stock, and it is during this building-up period that investment booms. But once the desired levels of capital have been achieved, the rate of investment can be expected to return to somewhere near its previous rate. There is evidence that investment is indeed slowing.

Next we consider the standard case for believing that government deficits crowd out private investment. The basic idea is that when the government borrows it adds to the demand for capital, raising the market rate of interest. Private investment, which is sensitive to the rate of interest, declines. This reduces the rate of capital formation, with the costly effects decribed earlier in this chapter.

How could this simple analysis be wrong? Those who downplay the importance of deficits make the following arguments (with which we disagree):

1. *"The government borrows in world capital markets, which are so large that they can supply all the capital we want with no increase in the rate of interest."* But the United States is not a small country, and its voracious appetite for capital has co-oped a significant portion of total capital availability. In 1984, the current account deficit of the United States absorbed 12 percent of total foreign net private saving. Moreover, the willingness of foreign investors to hold the debt of any country is clearly limited if that country's ratio of debt to GNP is growing rapidly or if there is the slightest hint that that country will attempt to monetize its debt. An infinite supply of capital from abroad is, we believe, a very tenuous assumption.

2. *"Domestic savings increase by whatever amount is needed to finance the public debt, without raising interest rates."* This assumption seems even less realistic than the previous one, particularly in light of the fact that real interest rates are high by historical standards. One version of this argument is that people understand that current governmental borrowing means higher taxes sometime in the future and that they, therefore, increase their savings to pay these taxes. This assumption of "rational expectations" seems far-fetched. While empirical evidence on the subject is mixed, it would be a bold analyst indeed who would base fiscal policy on the belief that an increase in borrowing would call forth enough new saving not to drive up interest rates.

3. *"Investment is not affected by higher interest rates."* It is highly implausible to argue that corporations and individuals would invest the same amount regardless of the level of interest rates. The relationship between the costs of capital and the rate of investment is well established by economic research, and this is perhaps the weakest of the three assumptions that are needed to reject the standard crowding-out theory.

In summary, we believe that high and persistent government borrowing will ultimately reduce the rate of capital formation. To argue otherwise requires assumptions that simply are not well justified.

In addition to this textbook argument for crowding out, there are other reasons to believe that deficits are injurious to the economy. Deficits are likely to cause uncertainty, which of course is poisonous to the investment climate. This uncertainty stems from several sources. Deficits create doubts about how they will be financed. This gives rise to speculation about tax increases, budget cuts, and continued heavy borrowing in capital markets. Regardless of what combination of these policies is adopted to deal with the deficit, there is still the gigantic stock of government debt in world credit markets. Will the Federal Reserve falter in its so-far steadfast determination to keep inflation in check, or will it succumb to the temptation to monetize part of the debt? How will this affect inflation? Speculation over these questions causes great uncertainty, which tends to raise interest rates and make corporations chary of long-term capital commitments.

How To Reduce the Deficit

Given the almost universal condemnation of the budget deficit, one might think that a balanced budget would be enacted immediately. But, of course, there are extremely difficult political problems in deciding how to achieve balance. These problems are beyond the scope of this chapter. Rather, this section will deal with the economic considerations relevant to deficit reduction.

Specific goals of deficit reduction.—There are several possible objectives: a balanced budget; a stable ratio of debt to gross national product; a stable but reduced ratio of outlays to GNP; and a zero "structural" deficit. We recommend that deficits be reduced over a number of years until the budget is balanced.

While a balanced budget is the most straightforward goal, some analysts have seen this as too "harsh," preferring instead merely to stabilize the ratio of debt to GNP. Accomplishing the latter would require only that the ratio of deficits to GNP be no larger than the growth rate of GNP. In other words, this would mean reducing the deficit from about 5 percent of GNP to about 3 percent of GNP, or—in dollars—reducing the deficit by less than $100 billion.

Although a stable deficit-to-GNP ratio would surely be preferable to the current situation, it has little else to recommend it. It would mean that the interest burden would remain at its present high ratio to GNP and to government outlays. Any deviations from the goal, owing to recessions or faulty forecasts, would likely to be on the side of greater deficits, thus increasing debt/GNP. In our view, this approach puts too much emphasis on the macroeconomic effects of deficit reduction, which we discuss next.

Macroeconomic effects of deficit reduction.—Much of the resistance to deficit reduction has come from those who fear that by lowering government spending we would either throw the economy into a recession or at least put countercyclical fiscal policy into a straightjacket. But it is strange to argue that deficits are bad for the economy and at the same time say that deficit reduction is also bad. Clearly, we would not recommend a one-year budget cut large enough to eliminate the deficit, since this would cause a serious contraction in aggregate demand. But a goal of balancing the budget over a period of five years seems quite achievable so long as monetary policy is not overly restrictive.

As for countercyclical discretionary fiscal policy, it never has worked particularly well. Too often, stimulative public works have been delayed until the economy was at a business-cycle peak, and tax increases in recent years have borne no consistent relationship to the business cycle. Even the 1981 ERTA tax cuts, which President Reagan had advocated as incentives to growth in 1980, did not fully take effect until the recession was over. If a schedule of deficit reduction interferes with such futile attempts to fine-tune the economy, so much the better.

We believe strongly that a balanced budget should be reached by means of a specific schedule of annual deficit reductions. As argued earlier, one of the most harmful aspects of the budget deficit is the uncertainty it engenders in financial markets. A complex deficit-reduction schedule, with escape clauses to be enacted in response to

wiggles in the economic statistics, would be essentially unpredictable and would do nothing to reduce economic uncertainty.

Cut spending or raise taxes?—Budget-balancing debate thus far has emphasized reducing spending, and this is where we believe *all* of the change should occur. Federal revenues, as a portion of GNP, are currently the same as in 1978—at 19.1 percent. Total budget outlays, however, have risen from 21.9 percent to 24.5 percent, accounting for all of the increase in the deficit-to-GNP ratio between 1978 and 1985.

The taxes-versus-spending-cuts decision is not an easy one, for it utlimately depends upon the relative value our society places on public goods versus private goods. We do, however, caution against making the decision on the basis of simple macroeconomic models, or even the more complex econometric models. Such an approach would show virtually no difference between tax increases and spending reduction because in a Keynesian macro model both would show equal removals of funds from the flow of income and nearly equal depressive effects on aggregate demand. This is only a short-term effect, and one that can be ameliorated by appropriate monetary policy together with market expectations of the favorable impact of deficit reduction. More important are the disincentive effects to savings, investment, and labor-force participation that would accompany tax increases. Raising taxes would be throwing the economy into reverse, putting us back into the earlier stagflation situation, and undoing all of the good of the tax-rate reductions of President Reagan's first term.

Taking another approach to the question, we should remind ourselves why we want to reduce the deficit in the first place. It is because, as was argued above, that debt burden tends to reduce capital formation and causes a growing tax burden to pay interest on the debt. It follows that our solution to the deficit problem should not be one that makes the real problems even worse. Higher taxes are indeed a burden, regardless of how their revenues are used.

Perhaps the worst possible way to reduce the deficit would be a tax increase that falls heavily on capital formation. This approach could, depending on the form of the tax, be even more harmful to capital formation than the deficit is now. In that connection, in the context of the tax reform debate now before the Congress, we should not take any action that would increase the cost of capital or discourage capital formation.

Which spending to cut?—Discussion of specific program cuts is beyond the scope of this study. We do wish to make one point that should by now be fairly obvious: budget cuts should be as broadly based as possible, with only the most vital programs set aside from spending reductions. If too many programs are held harmless, then the cuts mandated for the other programs will be too large to be politically or economically feasible.

Economic Effects of Reducing the Budget Deficit

In order to gauge the economic consequences of deficit reduction, the JEC staff has analyzed several scenarios. We considered six different situations, comprising two rates of deficit reduction and—for each of these two levels—three mixes of tax increase and outlay de-

crease. In each of these six situations, we judged the likely effects upon eight important economic variables listed in Table 1 and discussed later in this section.

From our analysis, we conclude that deficit reduction would have beneficial economic effects if it (1) is accomplished mainly by spending reductions rather than by tax increases and (2) proceeds at a steady pace that assures budget balance by the early 1990's.

Terms of reference.—The first column of Table IV.1 shows the 1985 values of the economic variables that we considered. *All comparisons in the rest of this section refer to these values.* For example, if we say that deficit reduction will make GNP growth higher, we mean that our estimate of the growth rate of GNP from 1990 to 1991 is higher than the 1984-to-1985 figure shown in Table IV.1. Also included for general reference are CBO's projections of four of these variables for 1990 assuming no deficit reduction, i.e., a 1990 deficit of $285 billion.

The two rates of deficit reduction that we considered are, first, that the budget deficit is $100 billion in 1990 and is reduced to $70 billion in 1991 and, second, that the deficit is $30 billion in 1990 and is eliminated in 1991. The three mixes of policy for deficit reduction that we considered are: entirely by means of tax increase; half tax increase and half outlay reduction; and entirely by means of outlay reduction.

TABLE IV.1.—BASELINE VALUES OF ECONOMIC VARIABLES

	Actual figures for 1985	1990 CBO projection (with $285 billion budget deficit)
Real GNP growth over previous year (percent)	2.4	3.5
Civilian unemployment rate (percent)	7.0 (November 1985)	6.3
Inflation (CPI-U) (percent)	3.2 (12 months ending September 1985)	4.2
Short-term interest rates (3-month Treasury bills) (percent)	9.84 (November 1985)	7.2
Long-term interest rates (10-year Treasury bonds) (percent)	7.1	N/A
Real gross nonresidential investment growth over previous year (percent)	6.2	N/A
Value of the dollar (March 1973 = 100)	130.7 (October 1985)	N/A
Merchandise trade deficit	$145 billion (JEC estimate)	N/A

Real GNP growth.—Balancing the Federal budget by 1991 will have beneficial effects on real economic growth *provided* the balancing is done in the proper way—through spending cuts and *not* through tax increases—and assuming that monetary policy does not become a source of economic contraction.

The adverse fiscal impact of removing annual deficits of more than $200 billion per year from the system would be more than offset by releasing sizable financial and real resources from the public sector to the private sector, thus increasing the efficiency of resource allocation, with beneficial effects on economic growth.

With no budget action, real baseline GNP growth in 1991 would be in the 3.5 percent range. With partial deficit reduction, real GNP could rise close to 4.0 percent that year if all the deficit reduction is accomplished through spending cuts.

If we go the tax route, however, particularly if the tax package includes a heavy dose of taxes on business, the beneficial effects of cutting the deficit to $100 billion are completely wiped out—and more. Real GNP would be rising at a "growth recession" rate of only 1.5 percent by 1991. If the deficit reduction is accomplished by a 50-50 spending tax cut increase package, economic growth would proceed at the moderate pace of 2.8 percent, not much better than its 1985 performance.

The best scenario is a fully balanced budget by 1991, through spending cuts. On that basis, real GNP would rise at a healthy pace, approaching 4.5 percent in 1991.

On the other hand, if we attempt to balance the budget solely by tax increases, economic growth would be seriously stunted, rising at only 1 percent by 1991. Approximately $1 trillion in cumulative tax increases would be devastating to incentives to save, invest, and work, and are particularly harmful if businesses bear a large share of these tax burdens. Even individual taxes have an effect on individual proprietorships and partnerships, which make up nearly half of the business sector output. Thus, any form of taxation would hit business one way or another. This, in turn, would have serious adverse effects on investment, employment, and real economic growth.

Unemployment.—Assuming no major shifts in the pace of growth of the labor force between now and 1991, which we do not anticipate, the civilian unemployment rate should correlate inversely—and quite closely—with changes in real GNP. The best situation is elimination of the deficit by spending reductions in 1991, at which time real GNP would be growing well over 4 percent per year and the unemployment rate will be at the "full employment" rate of 6 percent, or 6.2 percent if we reduce the deficit to $100 billion in 1990 and $70 billion in 1991.

Such institutional and social factors as unemployment insurance, minimum wage laws, welfare programs, high tax rates, increasing female participation in the labor force which increases the number of two-plus earner families, affect the aggressiveness with which the unemployed seek work and, accordingly, affect the "natural" or "structural" rate of unemployment. That "natural" rate has been rising over the long term—from 3 to 5 percent in the early postwar years to at least 6 percent, and probably more than that, today. Thus, even under the best of conditions, 6 percent is the lowest rate of unemployment that we can expect without major institutional and social change in our system, and without bringing strong inflationary pressures.

If the budget is balanced through tax increases, havoc is wreaked with capital formation and job creation; unemployment could rise to 10 percent by 1991. Incomplete deficit reduction would raise unemployment to 9.5 percent. It is not the lack of significant deficit reduction that is so harmful to the economy and employment, but tax increases. If we balance the budget by a combination of spending cuts and tax increases, the unemployment rate rises to about the middle of the range of the above scenarios—8.5 percent on a fully balanced basis, and 9 percent on a partial deficit reduction. Only if we reduce the deficit by spending cuts do we get favorable

conditions for economic growth and rising employment with corresponding reductions in the unemployment rate.

Inflation.—As suggested in our report, inflation is primarily a monetary phenomenon. Therefore, we do not expect changes in fiscal policy to have a significant impact on inflation over the next five years. However, to the extent a more "restrictive" fiscal policy is offset by a looser monetary policy, a higher inflation rate may result.

Deficit reductions achieved with significant tax increases would severely reduce economic growth while raising unemployment, thus reducing inflationary pressures. On the other hand, heavy tax increases on business would tend to increase the costs of production, putting upward pressure on consumer prices. These two countervailing forces could largely cancel each other out, however. The debilitating effects of large tax increases are sufficiently strong to demoralize business confidence, weaken aggregate demand, and thereby overwhelm the upward cost pressures of higher taxation and any monetary stimulus.

If the fiscal 1990 budget deficit were to be reduced to $100 billion, the inflation rate would be pretty much the same whether this were accomplished through tax increases only, spending cuts only, or a 50/50 mix of the two. By relying on spending cuts alone, the inflation rate (measured by the CPI–U), would be 4.2 percent, slightly higher than under the other two options. The stronger GNP growth rate under the spending-cut option is consistent with higher monetary growth and tighter markets for labor and other factors of production.

If the fiscal 1991 budget deficit were eliminated entirely, the inflation rate is predicted to be 4.2 percent whether the deficit reduction were accomplished through tax increases only or a 50–50 mix of taxes and spending cuts. Under a deficit reduction composed only of spending cuts, inflation will be 4.9 percent due to faster economic growth and consistent with faster money growth and tighter markets for factors of production.

One wild card in the inflation outlook concerns the relationship between the value of the dollar and the domestic inflation rate. It is argued that significant budget deficit reduction might reduce capital inflows and thus weaken the dollar, making imports more costly. The higher prices of imports and the lessening of cost competition with domestic producers could tend to increase inflation. On the other hand, most of the current net capital inflow is not being used to finance the budget deficit, and the higher economic growth associated with efforts to reduce the deficit by spending cuts might encourage foreign investment in the United States, strengthening the dollar and thus put some downward pressure on prices.

Interest rates.—The determination of short term interest rates is governed by the underlying real rate of return on capital and the supply of savings at the margin (determined by the time-preference of savers) as well as by any impact on the supply of savings by expansions or contractions in the monetary base.

We must presume a neutral monetary framework in order to analyze the impact of the taxing versus spending-cut, deficit-reduction policies.

Because the time-preferences of indivuals, the trade-off between "consumption now" and "consumption later," as well as the real yield of capital, are perceived only on an after-tax basis, short-term interest rates are lower to the extent that deficit reduction is accomplished by means of spending cuts and higher to the extent that taxes are imposed to balance the budget.

Because of the double taxation of savings under an income tax system (triple taxation if business profit taxes are an important source of revenues), any proposal to balance the budget by means of tax increases will tend to reduce the supply of savings, while cuts in government spending will tend to increase the supply of savings and the stock of real capital. This concluson is not materially affected by the form of tax increase, because even a tax on "consumption" will adversely influence the savings rate if savings are viewed as deferred consumption.

In the scenario with a more aggressive budget reduction, the relative effects of tax increases versus spending reductions are magnified.

Long-term interest rates are affected much less by the impact of weekly or monthly manipulation of the monetary base than are short-term rates, but inflationary expectations—erosion in the purchasing power of the unit in which the principal values or tend are stated—and the overall stock supply of securities play a significant role.

The differential impact on interest rates from a tax increases (as opposed to a cut in spending) that we found in the case of short-term rates would also apply to long-term interest rates, Yet, in the case of continuation of deficits along the CBO baseline, long-term rates would tend to drift upward from present levels due to the accumulation of government bonds in portfolios and competition from private sector capital needs.

If the deficits can be reduced, long-term rates would fall as the market anticipated and found less competition for investment capital over several decades. This decline in long-term rates, however, would be blunted if the adverse effect of tax increases were imposed on an otherwise favorable movement toward reduced borrowing by the government.

Investment.—Business investment is determined mainly by the level of economic activity, interest rates, tax provisons, and the degree of uncertainty about future conditions. With deficits continuing as in the CBO baseline, business investment would grow no faster in 1991 than in 1985. The projected 3.5 percent GNP growth, higher long term interest rates, and increasing uneasiness about the huge debt burden would hold investment down.

In our deficit-reduction scenarios, investment does the best when the deficit is reduced to near zero by means of spending cuts, because this gives the best GNP growth, the lowest business taxes, the lowest interest rates, and the least degree of uncertainty about future inflation. In this situation, we project investment growth well above 10 percent in 1991. In fact, all of the deficit-reduction scenarios offer reduced business uncertainty, a positive factor that cannot be adequately captured in simulations by econometric models.

The worst outlook for investment results when deficit reduction is accomplished entirely, or even partially, by tax increases. Not only does this policy slow the economy, it reduces the incentive to invest by reducing the after-tax rate of return to capital. (We are assuming that any tax increase sufficient to cause significant deficit reductions would include substantial increases in taxes on investment.) The worst situation would be incomplete deficit reduction accomplished by tax hikes, where we would project declining business investment.

Value of the dollar.—The foreign exchange value of the dollar is most heavily influenced by the growth rate differential between the U.S. economy and foreign economies. This general explanation broadly encompasses all of the factors that affect the demand for capital, including both the government deficit, real private-sector investment opportunities, and the interest rate differential that may result from the combined public and private sector demand for funds in a high-growth/high-deficit environment, such as the United States is experiencing in the 1980's.

With a baseline continuation of existing policies, there is no reason to expect either a secular rise or a decline in the foreign exchange value of the dollar. With a reduction in the government deficit, however, there would be reduced pressure on U.S. capital markets, and an increased opportunity for domestic funding of capital offerings. We expect this movement in supply and demand conditions to bring a moderately lower exchange rate, with the rate even lower to the extent that deficit reduction is produced by tax increases.

Tax increases will tend to depress the foreign exchange value of the dollar because of their depressive effect on economic growth. A reduction in economic growth would tend to reduce the demand by the private sector for capital, reducing one of the main driving forces behind the relatively high dollar exchange rate in recent years.

Trade deficit.—Significant reductions in the budget deficit will help reduce the U.S. merchandise trade deficit by reducing net capital inflows that have been necessary to finance Federal borrowing. This would lower the value of the dollar, thereby making our goods more competitively priced.

The maximum reduction in the trade deficit occurs in the all-tax-increase scenario, since higher taxes slow economic growth, thereby reducing the U.S. demand for imported goods. But even in this case the trade deficit is projected to be $30 billion in 1991. It is unrealistic to expect the United States to generate an absolute balance in the trade account so long as the other problems, to be discussed in the chapter on international trade, continue.

In our preferred policy scenario—complete elimination of the budget deficit by means of spending cuts—the trade deficit is expected to be reduced to about $50 billion in 1991.

An Economy Without Deficits

The Federal deficit must be greatly reduced because the current economic situation is not sustainable in the face of rapidly increasing Federal indebtedness. So far, most of the damage has fallen

upon our export- and import-competing sectors. If the colossal deficits continue, we can expect the crowding-out effects to spread to capital formation in general, with consequent reduction in the growth of output and productivity. Interest payments will take ever larger shares of the Federal budget, making it harder and harder to manage fiscal policy.

Let us conclude this Chapter with more emphasis on the positive aspects of deficit reduction. If we succeed in getting the deficit to near zero by means of a five-year program of spending reductions, we can look for the following beneficial results:

- Long-term interest rates may decline by nearly 3 percentage points from current levels.
- Capital formation, including business investment and housing, will be significantly stronger over the long term.
- The favorable view that the financial markets would undoubtedly take of a believable deficit-reduction package would help keep the current expansion going at least a year longer than it otherwise might.
- U.S. export industries will find it easier to compete, thanks to easing of demand for the dollar.
- Monetary policy will be easier to manage without the complication of $200 billion plus of deficit financing.
- Tax reform will be easier to achieve, since holding down the growth of interest payments will make it easier to keep tax rates down.
- Once we have adjusted to a new regimen of pay-as-you-go budget management, wasteful government spending habits will not be fallen into so easily.

All of this adds up to a much stronger economy in the long term. Without question, the process of deficit reduction is a headache on a grand scale. But the prospects for economic health—not to mention the chances of horrendous and probably irreversable economic damage in the absence of deficit reduction—make a program of deficit reduction *now* a vital investment.

V. MONETARY POLICY IN AN ENVIRONMENT OF DIMINISHING DEFICITS

Assuming a major shift in fiscal policy in the direction of a balanced Federal budget, three major questions arise:

- Should the priorities of monetary policy under these circumstances be different from the general principles of monetary stability?
- What should be the nature and magnitude of the monetary response, if any?
- If the reduction in fiscal stimulus—a cut in Federal spending—could be offset by an increase in monetary stimulus, how great would it have to be and what might be its secondary consequences?

There are a number of important reasons to recommend no specific monetary accommodation at all. There is even more reason to suggest some formal constraint on discretion in monetary policy during a period of successive fiscal shocks, caused by a substantial cut in spending, in order to reduce uncertainty originating in the monetary sector.

The neo-Keynesian synthesis that dominated macroeconomic theory for most of the postwar era is no longer universally accepted. In the past five years, monetary policy has assumed a more conspicuous role in macroeconomic policy simulations and forecasts for two very practical reasons: First, the dramatic expansion of Federal budget deficits has rendered impotent the fiscalist theory that government deficit spending can be an important tool in business cycle stabilization. For fiscal policy to be a tool of macroeconomic management, it has to be flexible; the past five years have proven how inflexible the Federal budget is on the down side. Second, the recession of 1982, coming in the face of a large tax cut and rising Federal outlays, was so obviously a monetary phenomenon.

In modern times, the force of fiscal policy has been less than the force of monetary policy. Thus, economists and policymakers turn their attention increasingly to short-term considerations of Federal Reserve policy for clues about economic growth.

The presumed objectives of the Federal Reserve today are price level stability, a moderate rate of economic growth, a moderately declining dollar in the foreign exchange markets, and relatively stable interest rates. It seems intuitively clear that with a dramatic shift in fiscal policy toward a balanced budget, some of these objectives may have to be given more emphasis than others. Yet, if fiscal policy is either much weaker in its impact than monetary policy or if rigid shifts in market anticipations of policy outrun the best guess of the policy planners, a relatively small adjustment in monetary policy could successfully accommodate large reductions in Federal spending. The econometric study presented in the Appendix of this report is consistent with this policy experience.

A Closer Look at the Macroeconomic Models

The predominant economic models that might cast some quantitative light on the appropriate monetary policy, given reduced deficit spending, unfortunately are based on the older neo-Keynesian paradigm, which treats reductions in government spending or increases in taxes as strongly contractionary due to the reduced absorbtion of resources by the public sector or by reduction in disposable income by the private sector. The fiscal contraction is then amplified by the "multiplier-accelerator" process. In these models, changes in monetary policy affect real GNP through interest rates, leading to changes in private borrowing to finance consumption and investment. The empirical relationships that give these models credibility are estimated over short periods within relatively narrow ranges of variability, when behavioral factors can be treated as given by a stable stochastic process.

The predominant macroeconomic models, however, seem not to be a reliable guide. Theoretical innovations in the last decade have attacked their general view of the world by denying their fundamental assumptions—that fiscal contractions always reduce private spending and production, and monetary expansion always reduces interest rates. The classical view, which preceded the development of Keynesian models, held that wages and prices, barring institutional constraints such as price-fixing by cartels or labor unions, always adjust toward full employment of capital and labor. Although unexpected shifts in policy can interrupt expectations, and adverse policies can affect incentives and economic efficiency, the "new classical" view provides an alternative modeling framework that explicitly incorporates a more credible, rational behavioral response to changes in government policy.

Thus, in order to predict the effect of any proposed policy, it is necessary first to factor out the extent to which it is a departure from previous policy, whether official or not. Any analysis of the economy's historical responses to fiscal and monetary policies would also require a similar analysis of past policies. This fact seriously complicates the mathematical techniques of the models, and at the same time casts very serious doubt on the reliability of the Keynesian models, estimated on historical data.

These theoretical innovations suggest that if people expect drastic deficit-reduction measures, the implementation of such measures might have little short-term effect on real GNP. Some element of surprise would, of course, remain in the timing and implementation of the deficit reduction, to the extent it cannot be anticipated. However, most economists would agree that forward-looking financial markets may well cause interest rates and exchange rates to fall quickly when budget reductions are announced, permitting investment and net exports to begin rising, partially offsetting any impacts of fiscal policy contraction. The implication for monetary policy is that accommodation would be relatively easy and, more important, it need not excite destabilizing inflationary expectations.

Divergent Results in Four Popular Models

To demonstrate how misleading econometric simulation can be, consider the following results. The Congressional Budget Office has performed some simple simulation experiments with four macroeconomic models. The CBO did not publish the results for the purpose of describing an economic process, because the models used do not by any means exhaust the range of reasonable viewpoints, but the simulations do reveal the serious limitations of models founded on the neo-Keynesian synthesis. Needless to say, the JEC does not endorse any of these results.

The models used the quarterly macroeconomic models of Data Resources, Inc., Wharton Econometric Forecasting Associates, Economica (Fairmodel), and an implementation of the St. Louis monetarist model. No attempt was made to simulate any "rational expectations" models, which would in any case predict a more transitory and moderate impact of deficit reduction on GNP.

The macroeconomic models were simulated by CBO assuming a Federal spending reduction of $20 billion in the first year (less than 1 percent of GNP in each case) rather than the very large changes contemplated by Gramm-Rudman-Hollings.

The reason for taking a smaller increment is that the reliability of macroeconomic models fails when they are used to simulate circumstances very dissimilar to those of the preceding period over which their equations were estimated.

Indeed, CBO reports that some models would not be capable of producing a solution. If the results of these $20 billion simulations could simply be extrapolated to a $100 billion cut in one year, the models would call for much larger, and probably infeasible, offsetting increases in money growth. Clearly, the results cannot simply be multipled by five, as that would imply in the Keynesian models a drop of between 4 percentage points and 8 percentage points in the Treasury bill rate, driving it (depending on the baseline) close to or even below zero.

In fact, if the economy worked as the Keynesian models do, there would be severe dangers in attempting to use monetary policy to offset a very large spending reduction. The monetarist model requires an increment of only 1 percentage point in money growth to avoid any impact on GNP, but this is the result of the view reflected in that model, that fiscal policy hardly matters. The model discussed in the appendix of this report is similar to a monetarist model, inasmuch as it is sensitive to small changes in interest rates.

Table V.1 presents the impacts on the economy of an assumed $20 billion cut in Federal spending from the current baseline forecast of the model vendors. Money growth (M1) is held unchanged from its baseline path. In every case, real and nominal GNP is lower in the first year than it would be without the spending cuts, and interest rates are lower.

Table V.2 presents the results of simulations that attempted to adjust monetary policy to minimize the impact of the fiscal policy change on nominal GNP. The attempts were not uniformly successful because the paths of M1 growth in these simulations are drastically different, ranging from 0.2 to 1.9 for the first year.

TABLE V.1.—SIMULATED EFFECT OF A $20 BILLION SPENDING CUT—MONEY HELD CONSTANT

[Percentage point changes from each model's baseline]

	First year	Second year
GNP:		
Fair	−0.7	−0.7
WEFA	−0.8	−0.9
DRI	−1.1	−1.1
St. Louis	−0.2	−0.2
Real GNP:		
Fair	−0.6	−0.4
WEFA	−0.8	−0.8
DRI	−0.9	−0.7
St. Louis	−0.2	[1]
M1 Growth (four-quarters):		
Fair	0.0	0.0
WEFA	[1]	[1]
DRI	−0.1	−0.1
St. Louis	0.0	0.0
Short interest rate (average of four quarters):		
Fair	−0.1	−0.2
WEFA	−0.1	−0.2
DRI	−0.5	−0.6
St. Louis	−0.1	[1]
Long interest rate (average of four quarters):		
Fair	[1]	−0.1
WEFA	[1]	−0.1
DRI	−0.3	−0.5
St. Louis	[1]	[1]

[1] Less than 0.05.
Source: Congressional Budget Office.

TABLE V.2.—SIMULATED EFFECT OF A $20 BILLION SPENDING CUT—NOMINAL GNP HELD CONSTANT

[Percentage point changes from each model's baseline]

	First year	Second year
GNP:		
Fair	[1]	0.1
WEFA	[1]	[1]
DRI	0.1	[1]
St. Louis	0.0	0.0
Real GNP:		
Fair	0.1	0.1
WEFA	−0.1	−0.1
DRI	−0.1	−0.1
St. Louis	0.0	0.0
M1 Growth (four-quarters):		
Fair	1.9	0.2
WEFA	0.6	0.5
DRI	1.3	−2.2
St. Louis	0.2	[1]
Short interest rate (average of four quarters):		
Fair	−1.6	−0.6
WEFA	−0.8	−0.6
DRI	−1.6	0.6
St. Louis	[1]	[1]
Long interest rate (average of four quarters):		
Fair	−0.8	−0.7
WEFA	−0.3	−0.2
DRI	−1.2	0.5
St. Louis	0.0	0.0

[1] Less than 0.05.
Source: Congressional Budget Office.

This section has demonstrated how unsatisfactory the popular econometric models are for policy simulation. The results vary greatly from model to model, and some of them apparently prescribe continued deficit spending as the only desirable policy.

Conclusion

Any conclusion about the appropriate monetary policy for rapid deficit reduction depends entirely upon the specifications of the macroeconomic model chosen. The economic models that call for a large accommodation by the Federal Reserve indicate that a moderate response might be deflationary; the models that suggest a moderate response seem to say that any large accommodation will be inflationary. This lack of accord obviously is no guide to that optimal policy.

The uncertainty about the actual relationships among very large Federal spending cuts and the change in real gross national product suggests that the response of the Federal Reserve could be the most important factor to analyze. Equally disturbing, there is no theoretical basis to expect that the Federal Reserve's response would not itself be the primary source of instability. One thing for certain, should the Federal Reserve be faced with a $20 billion cut in Federal spending, to say nothing of a larger reduction, it will receive little credible guidance from traditional econometric models.

To return to the three major questions at the head of this section, we believe the major priority of monetary policy in the uncertain short-term environment of major budget cuts should be the same as during a more normal period; namely, price-level stability. It would be more than ever impossible to "fine tune" economic growth at such a time, and exchange rates and interest rates, which always have a large element of speculative volatility, will be more susceptible to destabilizing speculation if the market starts to believe that price stability is *not* the Federal Reserve's primary objective.

The nature and magnitude of the monetary response should be a moderate expansion in the monetary base, not to deviate for any substantial period from 3.8 percent, which is approximately the sustainable long-term trend rate of real growth to which the economy would return after the initial fiscal shock. The monetary base is specified as the target variable here because the basic transactions money supply, M1, might actually decline in the transition period if the decline in gross national product induced by fiscal policy contraction were strong enough. If the expansion path of M1 did decline for more than one quarter, however, it would not be imprudent for the Federal Reserve to increase the expansion of the monetary base temporarily above 4 percent.

The third question posed at the beginning of this section raised the notion that it might be possible to determine the precise magnitude of any monetary "fine tuning" to hold the level of gross national product up during a fiscal contraction. As the discussion above has shown, it would be the epitome of folly to believe that any economist or economic model could answer that question, although some may believe they can. The monetary accommodation

reflected in the model discussed in the appendix of this report is not presented as a policy prescription, but only as a simulation for illustrative purposes.

VI. TRADE AND PROTECTIONISM

In contrast with the recent past, the strength and vitality of America's domestic economy—in terms of employment, price stability, and growth—increasingly depends on how well we compete for sales within a global marketplace. The United States must take maximum advantage of the commercial opportunities afforded by free trade.

A vital challenge facing the United States in the trade arena involves our worsening balance of merchandise trade position, which has shifted from a surplus of $1.2 billion in 1975, to a projected deficit of $150 billion in 1985. Why has the deficit grown so large? In substantial measure, because of a strong U.S. dollar, the result of huge inflows of foreign capital into the United States, some of which our government has used to finance its budget deficit. These capital exporting countries, in turn, need to run a trade surplus with the United States in order to acquire the dollars they subsequently lend to us. Reducing the U.S. trade imbalance, then, requires not only a forthright American program to redress unfair trade practices but also a serious commitment to reduce the Federal deficit. In taking this line of action, the Administration puts itself on record in opposition to shortsighted protectionist efforts which close off foreign markets to U.S. exports, and would actually worsen our trade deficit. We support the Administration's position.

The Congress occupies a pivotal role in discussions involving U.S. trade policy. In the face of huge import surges in the U.S. market, both Houses are understandably responsive to protectionist appeals, running the gamut from shoes to high technology. The result: more than 300 trade bills, a number of which may eventually become law—notably those that call for retaliation against countries that fail to open their markets to American goods. Confronted with growing constituency pressure, Congress has aggressively called for actions to limit imports of textiles, shoes, and copper.

Over the past several months, however, the Administration has come forward with a sensible, far-reaching program designed to (*a*) speed up enforcement of U.S. trade laws, (*b*) encourage a gradual depreciation of the dollar, while (*c*) calling in our trading partners to accept a larger share of the global trade burden through more expansive import policies.

Two vital questions surround congressional discussions of U.S. trade policy: (1) Aside from the U.S. budget deficit, what are the major causes of our trade imbalance and (2) what can be done to reduce it?

Causes

Additional causes of America's growing trade deficit prominently include the following: Self-imposed export controls that reduce

commercial opportunities for American firms abroad; huge jumps in exports to the United States by countries that simultaneously restrict our imports; growing competition between the United States and other industrial countries for sales in third country markets; and continued sluggish growth in most nations. The consequence is that, in 1984, the U.S. merchandise trade balance continued to deteriorate. This balance, explains a recent report by the National Association of Manufacturers, "worsened as much in capital goods and 'high technology' products, sectors in which the United States is thought to be especially competitive, as in other industrial sectors. Hi-tech imports, since 1980, have grown at a 21 percent annaul rate, while exports have increased at an average rate of only 5 percent. This emphatically contradicts the assumption that the trade crisis only threatens uncompetitive or 'smokestack' industries." The result has been an overall decline in U.S. manufacturing competitiveness. In 1984, for example, U.S. imports of industrial goods jumped by 36 percent, while our exports grew by 8 percent, yielding a record $89 billion manufactured goods deficit. This constitutes 72 percent of our total trade imbalance.

Solutions

International trade constitutes a vital field of economic activity for the United States. On the international front, we remain the world's leading commercial power, as evidenced by last year's $559 billion worth of merchandise exports and imports—a turnover slightly less than the combined trade of Japan and West Germany. American trade actions are, accordingly, taken very seriously by our partners for the impact they might have on world growth prospects. A key consideration for the United States in this regard involves Third World exports, the proceeds from which are used to pay interest on loans from U.S. and other Western banks. The United States ran a $16 billion deficit with Latin American debtor countries alone in 1984. Short-sighted efforts to reduce access for Third World goods in the U.S. market could unintentionally drive these countries into bankruptcy, thus reducing their ability to absorb larger volumes of American goods in the future.

The percentage of U.S. imports covered by protection has jumped from 8 percent in 1975, to 21 percent today. As things stand, growth in trade is expected to slow from the impressive 1984 increase of 9 percent to between 2 percent and 3 percent this year, as a result of slow economic growth and the emergence of new protectionist barriers. With the world already awash in protectionism, the United States should do its utmost to discourage the spread of such self-defeating, "beggar-thy-neighbor" practices, which could easily push the world into another 1930's type depression.

On the domestic front, trade also occupies an important economic role. Over the years, low-priced imports have helped control inflation while providing new sources of innovation for American entrepreneurs. Imports of consumer electronics, automobiles, and other consumer goods, for instance, have become such an integral part of the "domestic" U.S. economy that, at least in these product areas, the "Made in America" label has lost its meaning. A case in point is found in International Business Machines, America's larg-

est computer manufacturer, a number of whose components are derived from overseas markets before final assembly in the United States. Despite slower growth in U.S. exports, the sale of American agricultural and manufactured goods abroad remains a vital source of foreign exchange earnings for the United States.

How can the United States most effectively proceed in righting its trade balance? The budget reduction measure recently enacted by Congress could help to the degree that it generates reductions in domestic interest rates and the dollar's value. Over the short term, however, two specific Administration trade initiatives constitute points of departure; namely, stepped-up efforts to improve foreign market access and tentative agreement by our European and Japanese allies to undertake greater domestic expansion while cooperating with the United States to bring the dollar's value into closer alignment with other Western currencies. Testifying recently before the Joint Economic Committee, Commerce Secretary Malcolm Baldrige estimates that such measures could reduce the U.S. trade deficit by $15 to $20 billion in 1986. Predicting future U.S. trade balances is extremely tricky. But if the dollar continues to depreciate at a steady rate, America's trade deficit could conceivably be further reduced by at least one-third by the end of this decade.

In the meantime, Congress would be well advised to support recent Administration initiatives to counteract unfair trade practices which seriously undermine America's ability to sell goods abroad. Part of this effort should be directed toward the support of a new, multilateral round of negotiations under the auspices of the General Agreements on Tariffs and Trade. With all of its imperfections, the GATT continues to embody a consensus on the merits of free trade—a consensus which can, and must, be employed by the United States to ensure improved access to overseas markets for the entire range of U.S. products, from agriculture, to services, technology, investment, and manufactured goods.

As a necessary complement to these multilateral efforts, however, the United States should continue to press for more expansive pro-growth policies in allied countries, designed to pull in larger volumes of imports as the United States gradually reduces its own imports. Moreover, the United States must correct its savings shortfall through fiscal reform and deficit reduction. For the past several years, this Nation has been the engine of global recovery. In order for that recovery to continue, America's allies must now be ready to play a larger role in generating global expansion.

But Congress must also be prepared to act on the bilateral level against countries that violate free trade rules. Immediate agenda items include European Community agricultural export policies; Japan's use of predatory export practices to win larger shares of the semiconductor market in the United States, while simultaneously refusing to open up its own semiconductor market to American firms; violations of intellectual property rights in a number of advanced developing countries; and an end to obstructionist efforts on the part of countries such as Brazil and India to a new round of GATT negotiations.

Conclusion

America's trade deficit did not emerge yesterday. It will not disappear tomorrow. Over the past several decades, the United States has seen its comparative advantage deteriorate—against Europe, Japan, and now a growing number of advanced Third World countries. But, if the Administration and Congress are serious in their joint commitment to reduce the Federal deficit, while ensuring non-inflationary growth, the United States should be able to successfully adapt itself to the new competitive challenge. If these domestic adjustments can be combined with the U.S. initiatives to ensure trade law enforcement, and a more realistic exchange rate regime, along with expanded growth in Europe and Japan, there is every reason to assume that America's trade deficit problem will disappear on its own—in a manner which ensures a new generation of global expansion through trade-generated growth.

APPENDIX

The following is an extract from a study prepared for the Center for the Study of American Business, Washington University, by Laurence H. Meyer and Associates, LTD., St. Louis, Missouri.

It is an econometric analysis of the effects of the Gramm-Rudman-Hollings deficit reduction proposal. The full Washington University study covers several different scenarios for balancing the budget by 1991—spending cuts fully accommodated by monetary policy, nonaccommodated or partially accommodated spending cuts, a combination of spending cuts and corporate tax increases and two recession scenarios—one where interim deficit targets are enforced and one where they are not enforced.

The following scenario is based on spending cuts with accommodating monetary policy. We believe this is the most desirable scenario.

BALANCING THE BUDGET BY 1991: AN ECONOMIC ANALYSIS OF THE GRAMM-RUDMAN-HOLLINGS PROPOSAL

By Joel L. Prakken, Laurence H. Meyer, and Chris P. Varvares [1]

I. Introduction and Highlights

The Senate recently adopted by an overwhelming bipartisan majority the Balanced Budget and Emergency Deficit Control Act of 1985. The legislation, sponsored by Senators Gramm (R., Texas), Rudman (R., N.H.) and Hollings, (D., S.C.) and hereafter referred to as GRH, would establish a path of shrinking deficits designed to balance the federal budget in 1991. If Congress and the President could not agree on appropriate fiscal initiatives, GRH would mandate automatic spending cuts to achieve the targets. The legislation would not require tax increases.

With today's concern over the potentially harmful effects of successive federal deficits in the neighborhood of $200 billion, GRH has progressed through the legislative process quickly and with relatively little public debate. Yet it would represent the most dramatic change in the budgetary process since the Budget Reform Act of 1974, and could have far reaching effects on the nation's economy for years to come.

This study reports estimates, generated with the Washington University Macro Model of the U.S. Economy, of the macroeconomic effects of GRH under a variety of assumptions regarding: 1) the economic climate likely to obtain in the absence of such legislation; 2) the response of the monetary authorities to shrinking deficits; and 3) the manner in which the budget is balanced. The results suggests that balancing the budget by 1991 with large spending cuts is possible if the move toward tighter fiscal policy is accompanied by a shift to more accommodative monetary policy. Furthermore, this change in the "mix" of policy could be achieved with no loss in real output and only slightly higher inflation. (See Table 1.) Additional benefits of such a policy include lower interest rates, stronger growth in private investment, a lower dollar and a dramatic reduction in our trade deficit.

II. Provisions of the Bill

GRH defines a path of maximum allowable deficits starting with $180 billion in fiscal year 1986 and ending with a balanced budget in fiscal 1991. The President would be constrained by these limits in formulating the Administration's annual

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budget, and Congressional budget resolutions also would be required to adhere to the targets.

Each year, the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) would be required to prepare estimates of the deficit for the ensuing fiscal year, taking into account expected economic conditions and anticipated Congressional fiscal initiatives. If the average deficit projected by CBO and OMB exceeded the mandated limits, the President would be required to make additional reductions in spending, subject to the following limitations:

(1) Social Security benefits (including cost-of-living adjustments, or COLAs) would be exempted from any cuts, as would be interest payments.

(2) Up to half of the additional cuts would come from reducing or eliminating "automatic spending increases" associated with COLAs or any indirect indexation of existing programs other than Social Security. However, the cuts in any indexed program could not exceed those achieved by eliminating the COLA. Nearly 25 percent of nondefense spending (excluding Social Security benefits) is devoted to programs with some form of protection against inflation.

(3) The remaining additional cuts would be achieved through proportional reductions of all expenditures classified by OMB as "relatively controllable." About 40 percent of defense outlays are currently so classified, as are another 20 percent of nondefense expenditures (excluding Social Security benefits).

The President may propose and Congress may pass an alternative plan to reduce the deficit. Otherwise, the automatic reductions in outlays mandated by GRH must be implemented. There is one important exception. If in any fiscal year the average forecast of OMB and CBO has real GNP falling by more than 1 percent, the President would be allowed to suspend any automatic reductions in spending that GRH would otherwise require. However, the mandated deficits in subsequent years would remain unchanged, implying a "catch up" to be accomplished in the first year of the ensuing recovery.

III. Key Issues

To gauge the economic ramifications of a serious attempt to balance the budget by 1991, three important issues need to be addressed: (1) What economic climate would prevail over this period in the absence of any attempt to pare the deficit? (2) How would the economy respond to large reductions in federal outlays? and (3) How would the monetary authorities respond if Congress moved toward tighter fiscal policy?

III.1. THE TREND BASELINE PROJECTION

As a point of reference this study assumes that through 1991 and absent any attempt to balance the budget:

(1) Real Gross National Product would grow slightly in excess of 3 percent a year.

(2) Inflation, measured as the rate of change in the All Urban Consumer Price Index, would average just less than 4 percent a year.

(3) The civilian unemployment rate would decline gradually to 5.7 percent.

(4) Short term interest rates would remain fairly stable, while long term rates would fall moderately.

(5) The trade-weighted exchange rate would remain steady at its current level.

(6) The federal budget deficit would rise steadily to around $300 billion by 1991.

(7) Nominal net exports would fall to nearly −$150 billion.

(8) The Federal Reserve would provide steady growth in the money supply (M1) of 6 percent a year.

The baseline projection was generated with the Washington University Macroeconometric Model using budgetary assumptions similar to those presented by the Congressional Budget Office (CBO) in the August update of its February baseline. The deficits generated in the trend baseline and the associated reductions in deficits that would be required under GRH are summarized in Table 1.

The baseline projection plays a vital role in determining the magnitude of spending cuts required to balance the budget. Since tax revenues rise as the economy expands (and, to a lesser extent, expenditures decline), the stronger is real growth in the baseline projection, the smaller will be budget deficits and the easier the task of eliminating them. Similarly, because not all aspects of the tax code are "indexed" to the price level, the higher is inflation in the baseline projection, the smaller will be budget deficits and, again, the easier the task of balancing the budget.

The Administration's budgetary figures frequently are faulted on the ground that its economic assumptions are considerably more optimistic than those of private forecasters. To avoid this criticism, the rates of inflation and real growth used here

as part of the baseline projection are roughly consistent with figures reported in a recent "Blue Chip" survey of fifty top forecasters. The figures are decidedly less optimistic than the Reagan Administration's and similar to those used by the CBO. The baseline projections of interest rates are more optimistic than CBO's, but less optimistic than the Administration's.

Note that the trend baseline projection does not assume the reductions in spending called for in the Congressional Budget Resolution passed last summer. The Resolution is nonbinding and, as of yet, cuts of the magnitude sought have not cleared the usual legislative hurdles. Furthermore, if the Gramm-Rudman-Hollings proposal (GRH) were implemented, the spending cuts mandated would supersede those outlined in the Budget Resolution. By starting from a baseline that excludes the Resolution, one avoids the problem of distinguishing between the economic effects of the Budget Resolution and GRH, and instead can focus simply on the economic ramifications of balancing the federal budget by the fiscal year 1991.

III.2. ECONOMIC FUNDAMENTALS

The results presented below are generated using the Washington University Macro Model and, accordingly, are dependent upon the structure of the model. While the properties of this system are, we believe, generally consistent with a "mainline" view of the response of the economy to changes in monetary and fiscal policy, it is worth stressing at the outset some of the key properties of the model.

The most important property is that, unless accompanied by additional monetary growth, a series of large reductions in government spending would, by undermining aggregate demand, retard economic growth and slow the expansion of taxable income for a time. Consequently, the ensuing reduction in the deficit would fall short of the "static" reduction implied by spending cuts alone. Thus, by itself, implementation of GRH would slow the economy and force larger cuts in spending than the "static" changes outlined in the bill. Furthermore, while slower economic growth would reduce interest rates, the decline in yields would prove insufficient to spur investment in the face of waning demand for output. Lower interest rates, however, would lead to a depreciation of the dollar, reducing the trade deficit and providing an economic stimulus to offset partially the decline in the federal government's demand for goods and services. The depreciation of the dollar would also result in higher inflation.

A more optimistic outcome would be realized if the Federal Reserve helped offset the decline in aggregate demand by assuming a more accommodating posture. For example, consider the case in which GRH is implemented but the Fed provides enough extra monetary growth to prevent real aggregate demand from falling below its baseline path. In this case, growth in taxable income would be maintained (indeed increased if depreciation of the dollar boosted inflation), and the consequent decline in deficits would actually exceed the corresponding "static" reductions as declining interest rates helped to lower federal interest payments. With demand unchanged relative to the baseline, but interest rates lower, the interest sensitive investment sectors of the economy would grow faster relative to the baseline as the composition of GNP shifted from the public to the private sector. Again, declining interest rates would produce a depreciation of the dollar that in turn would result in smaller trade deficits, albeit at the cost of some additional inflation.

The latter case, often referred to as a "fully accommodated" reduction in the federal deficit, has the potential to eliminate or at least reduce significantly both our internal and external deficits simultaneously. It does, however, require a carefully coordinated change in the "mix" of policy away from *loose fiscal/tight money to tight fiscal/loose money.*

IV. An Optimistic Scenario: Fully Accommodated Spending Cuts

The case considered is one in which, starting from the trend baseline, the Washington University Macro Model was used to simulate the effects of implementing the Gramm-Rudman-Hollings proposal on the assumption that (1) the budget is balanced through expenditure cuts alone, and (2) the Federal Reserve accommodates fiscal policy with enough extra monetary growth to keep real GNP practically unchanged relative to the baseline.

The assumed cuts in federal spending, estimated in accordance with the guidelines established by GRH, are summarized in the bottom portion of Table 1. Over five years, noninterest outlays are reduced by $235 billion. In addition, lower interest rates and smaller deficits help reduce interest payments by another $69 billion so that, by 1991, the federal budget actually moves into a slight surplus. The corre-

sponding unemployment rate is 6.0 percent, suggesting a "structural" surplus as well.

The amount of additional monetary growth required to maintain the baseline path of real GNP is quite modest. Because monetary policy affects the economy with a longer lag than does fiscal policy, initially the growth of M1 had to be raised nearly a full percentage point above the baseline (from 7.4 percent to 8.2 percent) to counter the decline in aggregate demand associated with GRH. However, the requisite annual growth of M1 falls steadily to 6.4 percent by 1991, only marginally faster than in the baseline. Hence, following the period of transition to the new mix of policy, no additional monetary stimulus appears necessary.

TABLE 1.—ESTIMATED EFFECTS OF THE GRAMM-RUDMAN-HOLLINGS (GRH) PROPOSAL: FULLY ACCOMMODATED SPENDING CUTS

	1985	1986	1987	1988	1989	1990	1991
Real GNP (% chg.)							
Baseline: trend	2.4	2.9	3.3	3.1	3.3	3.3	3.2
GRH	2.4	2.7	3.2	3.1	3.4	3.3	3.2
Consumer Price Index (% chg.)							
Baseline: trend	3.6	4.0	4.2	4.1	4.1	4.1	4.2
GRH	3.6	3.9	4.3	4.4	4.6	4.8	4.9
Unemployment Rate (%)							
Baseline: trend	7.2	7.0	6.8	6.8	6.5	6.1	5.6
GRH	7.2	7.1	7.1	7.2	6.9	6.5	6.0
Corporate Bond Rate (%)							
Baseline: trend	11.4	10.1	9.4	9.1	9.1	9.0	9.0
GRH	11.4	9.7	8.6	7.9	7.6	7.5	7.5
Net Exports (billions of $)							
Baseline: trend	−87	−95	−106	−113	−124	−135	−148
GRH	−87	−88	−85	−75	−55	−49	−29
Real Business Investment (% chg.)							
Baseline: trend	6.2	4.0	4.0	4.1	4.9	4.3	4.0
GRH	6.2	3.8	4.3	5.2	6.7	6.1	5.6
M1 (% chg.)							
Baseline: trend	8.8	7.4	6.0	6.0	6.0	6.0	6.0
GRH	8.9	8.2	6.7	6.5	6.4	6.3	6.4
Federal Budget (billions of $)							
Noninterest Outlays							
Baseline: trend	827	879	944	1016	1095	1175	1267
GRH	824	846	876	913	951	991	1032
Difference	−3	−33	−68	−103	−144	−184	−235
Interest Payments							
Baseline: trend	133	140	148	158	170	183	198
GRH	132	136	137	136	134	132	129
Difference	−1	−4	−11	−22	−36	−51	−69
Receipts							
Baseline: trend	766	814	866	948	1023	1095	1172
GRH	765	808	860	946	1026	1106	1189
Difference	−1	−6	−6	−2	3	11	17
Surplus or Deficit (−)							
Baseline: trend	−194	−205	−226	−227	−241	−262	−293
GRH	−191	−174	−153	−103	−59	−17	27
Difference	3	31	73	124	182	245	320

Source: Laurence H. Meyer & Associates, Ltd.

Table 1 reveals other benefits of the fully accommodated move towards a balanced budget. First, interest rates are dramatically lower. The AAA corporate bond rate, which in the baseline averages 9.0 percent in 1991, falls to 7.5 percent under the assumed changes in policy. Such a decline in yields would restore real interest rates to levels comparable to those experienced in the 1960's. Lower interest rates, in turn, spur the interest sensitive sectors of the economy. Business fixed investment, which in the baseline grows at about a 4.2 percent annual rate through 1991, grows at a 5.3 percent pace under the more favorable mix of policy. Lower interest rates also lead to a cumulative 20 percent depreciation of the dollar that, following a brief

period in which nominal net exports fall (the so-called "J. Curve" effect), starts the trade deficit on a steady decline. By 1991, net exports shrink to $29 billion, from $148 billion in the baseline.

There are costs associated with the policy initiative. The inflation rate rises modestly as the dollar's depreciation increases the cost of imports and provides domestic producers the opportunity to raise prices as well. This extra inflation could be expected to dissipate as real interest rates and the dollar stabilized following achievement of a balanced budget. The unemployment rate also remains above its baseline value. The reason is that for (approximately) unchanged levels of real output, the reduction in real interest rates induces a substitution from labor to capital. In addition, the sharp reduction in the availability of transfer income has the incentive effect of raising labor force participation. Ultimately, the relative price of labor would fall sufficiently to absorb the unemployed, but the transitional period is lengthy.

The apparently favorable terms on which a smooth transition to a balanced budget is accomplished reflect several properties of the Washington University Model that merit attention. The "fiscal multipliers" of the model—that is, the magnitude of the negative effect on aggregate demand associated with a cut in federal spending—are relatively small and dissipate quickly enough to make even large reductions in expenditures manageable. An important reason for this is that, in the model, private demand is quite sensitive to real interest rates. Therefore, a cut in spending that initially slows public demand for output and lowers financial yields automatically sets in motion forces that boost private demand to offset much of the negative impact of a decline in government spending. Part of this interest response works directly through gross private domestic investment. An important part, however, occurs as declining real interest rates undermine the value of the dollar and thereby boost net exports. The sensitivity of demand to interest rates makes it possible for the Federal Reserve to make up any shortfall in aggregate demand with relatively small increases in monetary growth.

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